THE SUBSTANCE OF ECONOMICS

FOR THE STUDENT AND THE GENERAL READER

BY

H. A. SILVERMAN

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PREFACE
TO FIFTEENTH EDITION

The Substance of Economics was conceived and published for the benefit of students and others who, it was believed, were in need of a book which combined a descriptive survey of the economic system with an elementary account of the governing principles, and which, furthermore, was presented in as concise a manner as was compatible with clear understanding. The continued and growing demand for the book indicated that such a need existed and that it was to some extent being met.

In this further edition the opportunity has been taken to introduce much new material and to bring the factual references and statistical tables up to date Several sections, especially those dealing with economic changes and readjustments, have been largely rewritten in the light of recent developments

H. A. S.

February, 1960

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INTRODUCTION

SECTION I

THE NATURE OF ECONOMICS

Nature and Definition of Economics

PEOPLE have wants and have to work in order to satisfy them. As time goes on their requirements grow in number and variety, while the methods and organization of supply become increasingly complex. In the following pages a study will be made of these wants, and the efforts that are exerted to produce those commodities and services for their satisfaction.

The older economists, applying the term "wealth" to all those things that are necessary to gratify one's needs, used to say that Economics was a subject concerned with the principles of wealth-getting and wealth-using This definition, however, did not satisfy economists who viewed the science as essentially a study of man. Marshall, for example, re-defined the science in the following terms, which acquired a wide acceptance—

"Political Economy or Economics is a study of man's actions in the ordinary business of life; it inquires how he gets his income and how he uses it . . . Thus it is on the one hand a study of wealth, and on the other, and more important side, a part of the study of man."

Some recent authorities, however, take a more restricted, yet it is claimed more scientific, view of the scope of Economics. They begin with the fact that the means of satisfying wants are limited, and define Economics as being concerned primarily with the study of human behaviour in relation to ends and to means that are relatively scarce. Thus Prof. Lionel Robbins defines Economics as being concerned "with the relationship between ends and scarce means which have alternative uses."

Fundamentally there is little difference between these views. Indeed there is much to be said for reverting to the old use of the term "Political Economy." *Polis* meant the city-state, which was the territorial and political unit of Greek civilization. *Oikonomia* signified household management The laws governing the management of the household were applied to the miniature state. In the same way as the housewife was expected to conserve and make full use of the household revenue, so the statesman was to strive at getting the maximum benefit for the community from the available income. Economic science, as we now understand it, has come to have a much wider scope, but it is still largely concerned with deriving the maximum advantage from limited resources.

Economics in Relation to Other Social Sciences

Economics is but one of several social sciences, each of which deals with one aspect of human behaviour. It may be regarded, for ordinary purposes, as an offshoot of the parent science of Sociology, which studies the general principles of all social relations. Other related sciences are Ethics, Politics, Jurisprudence, Psychology, etc., each of which deals with different aspects of human behaviour. The distinction between these sciences is largely one of convenience, and is more feasible in theory than in action. Especially in the working out of practical problems is it very difficult for the economist to remain uninfluenced by ethical and political considerations. This becomes inevitable as he goes beyond the narrow study of wealth, and concerns himself with social welfare In the modern community there is little point in drawing a distinction between the two branches of thought.

Methods of Study

In a scientific treatment of any subject facts are observed, collected and classified, and hypotheses and inferences are provisionally formulated. The validity of such laws as emerge is constantly being tested by reference to facts already established and to others as they become known.

The modern economist combines the inductive and the deductive methods.

The **Deductive** method involves the reasoning from a few fundamental propositions, the truth of which is assumed, to further propositions and conclusions. The "Classical" economists[1] of a century ago used this method, and tried to make all economic phenomena come within the framework of some half-dozen laws. These economists were followed by the "Historical" school, who preferred the **Inductive** method, whereby a number of facts were collected, generalizations made about them, and these, in turn, tested by reference to further facts. Great advances have been made in recent years in the collection and application of statistical and other factual data

Some branches of economics lend themselves better to one method than the other. The deductive method is suitable, for example, in dealing with the problem of valuation. The inductive method, on the other hand, is more appropriate in studying systems of production and distribution It is not always possible, however, to adopt one method to the entire exclusion of the other, and the best results are usually obtained when the two are combined.

Economic Laws

The "laws" of economic science cannot be expected to be so exact or be formulated in the same precise terms as the laws of the physical sciences Even as statements of bare tendency, which is all that the so-called laws commonly are, they are liable to be offset by external and changing circumstances. But the fact that the operation of an economic law may be counteracted or concealed does not disprove its validity. Conditions may require that the normal operation of an economic law should be prevented or mitigated, as for example in price-fixing in time of war or other emergency. Such action, however, is more likely to be effective if it is based on an adequate knowledge of economic principles.

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[1] See Appendix on "The Development of Economic Doctrine"

General Survey of Subjects to be Studied

In the definition given above it was stated that wealth is an important, though by no means the only, subject in economic science One may, therefore, begin the study of the subject with an inquiry into the nature of wealth and into the factors that go to produce it These factors and the principles governing their application are examined in the economics of PRODUCTION.

It is a truism that man's desires impel him to productive effort. His wants decide what and how much will be produced. These wants are studied under the head of CONSUMPTION, but the subject is so complex and so bound up with other social sciences, notably psychology, that in a book of this order only the simpler aspects of the problem can be considered

In developed communities there are very few people who produce for themselves everything they require. Modern conditions and requirements make it practically impossible for a man to be economically self-dependent, even if he desired to be so. Most people specialize in supplying a particular kind, or part, of a commodity or service, taking it for granted that other members of society are producing the rest of the things required. This assumption rests upon an effective system of evaluation and exchange of goods Hence the importance of the economics of VALUE and the MECHANISM OF EXCHANGE.

Having examined the principles of production and value, one proceeds to study the way in which the social income is shared out among the various factors of production, corresponding more or less to the different classes of the community The question of how much goes to labour, capital, and other agents, is discussed in the economics of DISTRIBUTION.

Finally, the position of the State in relation to industry and trade has to be considered. In this connection attention is given to national and local taxation, public borrowings, and the bearing on the economic welfare of the nation as a whole These and allied subjects are brought together under the head of PUBLIC FINANCE

Equilibrium and Variation

The interdependence of economic problems has led to a greater unity in presenting the science, and certain economists are content with pursuing two main lines of thought. the theory of equilibrium and the theory of variation. A danger in the traditional exposition of economics is that too much emphasis is placed on the social product and the distribution of this among the several claimants. In the alternative approach the economic system is considered as a series of relationships between men and economic goods, and inquiry is made into the circumstances (*a*) in which these relationships are constant (analysis of equilibrium) and (*b*) in which they change (analysis of variation).

The beginner, however, may find difficulty in embarking straightaway on these problems, and there is some advantage in following the conventional course, provided that the sections into which the subject is divided are not taken to imply a separation in reality, but are adopted simply as a convenient method of approach. Production, consumption, valuation and distribution are all inextricably bound together and no part of the economic mechanism can be properly understood without a knowledge of the system as a whole. In the following chapters, while the customary division will be largely adhered to, the interdependence of all forms of economic activity will be kept constantly in mind.

SECTION II

EVOLUTION OF THE ECONOMIC SYSTEM

Industrial Evolution

IN order to understand the present-day economic organization of society it is helpful to have some knowledge of the factors that brought it about. A study of economic history is, indeed, the necessary complement to that of economic science, but it is possible here to make only bare mention of the principal stages in the evolution of industry.

Economic evolution may be regarded from several standpoints. One may look at it from the viewpoint of production, or from that of exchange and the market, or from that of the social and economic unit.

In early times man's material wants were few and simple, and could be satisfied by his own direct efforts. Hunting and fishing were the principal means of living. As there was little specialization of functions, little exchange, no complex system of distribution, economic problems as we know them to-day did not exist. As time went on, man learned to tame and domesticate animals. This led to the pastoral stage, in which existence was made more secure and wealth was increased. What little exchange took place was effected by barter.

So far man lived a more or less nomadic life. The third stage, agriculture, was reached when he learned how to cultivate the soil The land, which at first was held in common, added to the material comforts and supported a larger population, which became less migratory and more fixed.

In primitive times, man had to be content with what he could *find*; subsequently his wants became more numerous and he began to *make* what he desired Alongside agriculture developed handicrafts, which gradually assumed an increasing share of man's activities. By now money was in regular use. Effort for the satisfaction of wants was becoming indirect, and the specialization of functions was growing more intense. Eventually, the factory era was reached Machine production supplanted handicraft to an ever-increasing extent, while, with the growth of a complex system of banking and credit, commerce as well as manufacture underwent a considerable change.

Growth of Social Unit

While this evolution was proceeding, the unit of social life was growing in size Beginning with the family in a tribal relationship, it developed into the manorial organization prevalent in the Middle Ages. The manor was a small community, economically self-sufficing Agriculture was the principal occupation of the people, who held and cultivated the land in common Almost everybody had a share of land, however small, the tenure depending on feudal dues and obligations Common pasture and cultivation practically disappeared as the manor decayed, though traces of the old system are still to be found in a few parts of England

The unit of communal life grew in size as the town evolved. Early town life was by no means inconsistent with agriculture, which was often carried on within the town walls. Indeed, the holding of land used to be a necessary qualification for a burgess

The town economy eventually developed into a national economy when the country as a whole became the economic unit, and this in turn is being replaced by an international economy

Changes in Industrial Structure

Corresponding changes took place in the industrial structure The main stages were—

(i) The Family System—Preceding and also contemporary with the medieval manor.

(ii) The Gild System—A town economy, from the Middle Ages to about the sixteenth century

(iii) The Domestic System—Coinciding with a national economy, roughly between the sixteenth and eighteenth centuries.

(iv) The Factory System—An international economy, typical of the nineteenth and twentieth centuries.

(i) **The Family System.** The household was the centre of economic life. Wants were very few and were usually satisfied by the family's own direct efforts, with comparatively little specialization. Agriculture was the main occupation, and the wages system, as now understood, was in its infancy. Organization accordingly was very primitive

(ii) **The Gild System.** The gilds were of first importance in the growth of the town, which gradually supplanted the manor as the social unit. Hence there was greater scope for economic enterprise, both in the size of the market and in the nature and variety of the products. In many towns there was a gild for each of the principal trades, and membership was strictly limited. The gildsman, as a rule, was a small master, according to present-day standards, working alongside a few apprentices and journeymen, and the body to which he belonged exercised a powerful control over the production, quality and sale of the goods

(iii) **The Domestic System.** As the gild system decayed, a new type of organization evolved in the form of the "domestic" system. People still worked in their homes, but—different from the "family" system—not for themselves, but for a merchant-employer. The *middleman* became prominent in industrial organization. The division of labour was extended, the organization being largely in the hands of the merchant, who was comparable to the modern employer. Relics of this system are still to be found among the home-weavers in the Hebrides.

(iv) **The Factory System.** In the last two centuries, the economic system has become very complex. Production is now for a world market, specialization of functions has become advanced and minute, the unit of business organization has enormously increased, while the mechanism of exchange has adapted itself to meet the new conditions.

The Industrial and Commercial Revolutions

The changes in our industrial methods and structure that came about during the eighteenth and nineteenth centuries are commonly described as the "Industrial Revolution." Hitherto, production had been relatively simple and on a small scale, carried on mainly by hand power, often in people's own homes Agriculture had been the principal occupation, and England, until the end of the eighteenth century, exported food. The governments of the sixteenth and seventeenth centuries, influenced by the prevailing Mercantilist views, had played a prominent part in the regulation of economic conditions. Thus, they had stimulated certain vital industries, had taken an interest in trading companies, had passed a series of Navigation Acts, and had imposed apprenticeship and wages regulations.

The industrial changes towards the end of the eighteenth century were accompanied by a reaction against the restrictive Mercantilism, whose place was taken by a policy of non-interference or *laissez-faire.* The new attitude was soon reflected in the legislation of the period, while it also facilitated the application of the new industrial methods.

The innovations were of several kinds First, there were the discoveries of new *resources*, such as wheat fields abroad and ore supplies at home, and of new foods, such as sago and tapioca.

Secondly, there were the inventions of new *processes*, so characteristic of the period Thus, in mining and engineering, came the development of the steam-engine, Cort's rolling and puddling processes, the mild steel processes, the Davy lamp, etc., in textiles, the flying shuttle, the spinning frame, the power loom, etc.; in agriculture, scientific fertilization, the rotation of crops, etc.

Thirdly, there was great progress in *transport*, without which the mechanical inventions could not have been so fully extended. The roads were developed, canals were constructed in the new industrial districts, while the application of steam-power led to the steamboat and the locomotive.

Fourthly, important changes occurred in the country's *economic structure* Thus, large-scale production with its attendant economies became the rule, joint-stock companies were promoted in every direction, while the banking and credit system received a great impetus

The advances that took place in commercial methods and structure, as distinct from the system of production in the narrow sense, were such as to merit the description of a Commercial Revolution. Besides physical developments in the transport and marketing of goods, modifications in finance, etc., radical changes were effected in the general economy. The small producer gave way to the large firm in most industries, and the joint-stock company facilitated the growth of combination and monopoly. The control not only of production but of the marketing and distribution of goods came to be vested in fewer hands. Thus the technological changes, usually associated with the Industrial Revolution, were by no means the only significant economic developments of this period; new methods were "invented" in finance and general organization as well as in the fields and factories.

The general results of the Industrial and Commercial Revolutions may be shortly noted Manufacture took the place of agriculture as the principal occupation. The centre of industry moved from the fields and the villages to the factories and the towns. Hand- and water-power were largely supplanted by steam-power, helped on by abundant coal and iron supplies. Population became concentrated in the industrial districts of the Midlands and the North, though in recent years there has been a tendency for industry and population to move southward again.[1]

The new large-scale enterprise, for a world instead of a national market, had important social as well as purely economic consequences. The absence of adequate control over the new methods of production was responsible for many evils and abuses, which went unchecked during the early part of the nineteenth century, when factory and social legislation was non-existent or ineffective, and the workers were practically unorganized. Though the national product was considerably increased, and all classes came eventually to benefit, the changes were not effected without great hardship.

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[1] See below, pp 42–43

PART I

PRODUCTION AND CONSUMPTION OF WEALTH

CHAPTER I

PRODUCTION AND CONSUMPTION

The Meaning of Wealth

WEALTH is sometimes taken to mean "anything that can satisfy a want," but this definition is not precise or limited enough to be of much service to the economist. There are some kinds of goods that involve no effort and are so abundant in supply that they do not give rise to economic considerations (e g air and sunlight). These *free goods*, as they are known, may be indispensable to life, but are not customarily regarded as economic wealth. On the other hand, should they become scarce or entail some effort or sacrifice in their supply, they become *economic goods* or *wealth* (e.g. fresh air pumped into a crowded cinema)

Economic Wealth may be defined as that which—

(i) Possesses utility, or the power to satisfy a want;

(ii) Is limited in quantity; and

(iii) Is transferable in its use (though not necessarily transportable) Economic conditions are ordinarily based upon exchange, and if the use of a commodity is not transferable no economic transaction can normally take place.

Wealth can be classified according to whether it is—

(i) *Personal*, e.g. skill of surgeon or artisan; or
Material, e.g. instruments or tools.

(ii) *External*, e.g. furniture, goodwill of a business; or
Internal, e.g. musician's ability.

(iii) *Private*, e g jewellery, clothes; or
Social, e.g. roads, public offices.

These divisions should not be regarded as rigid or mutually exclusive. For example, goodwill and skill, while respectively external and internal, are both personal. Indeed it is often an arbitrary matter whether a particular form of goods is regarded as wealth or not. Thus ample water supplies, navigable rivers, and so on might be excluded by the formal definition, yet obviously they count for much in promoting the wealth of the country that enjoys them. Paradoxically, if their supply were restricted, or they came under private control, they might acquire a commercial value, and the aggregate wealth might appear on that account to be increased, whereas in reality the actual wealth would be no greater and might, under a restrictive policy, be considerably less.

Wants and their Characteristics

The various kinds of wants which a commodity or service may satisfy do not permit of simple classification, but some general characteristics may be noted—

(i) *Wants are Unlimited and Recurrent.* A person's desire for one commodity or another may temporarily reach satiety, but over a period wants are recurrent and new wants are conceived.

(ii) *Wants are Competitive.* In consequence of the limitation of resources, people's wants compete for them. In another sense of the term, too, a want for one article may compete with a want for another.

(iii) *Wants are Complementary.* One want goes with another so intimately in fact that complete satisfaction is impossible without them both—e.g. a toothbrush and toothpaste.

Nature of Utility

The utility of a thing is its power to satisfy a want, and should be distinguished from "usefulness" in any moral sense. It is not the purpose of the economist, strictly speaking, to determine whether a want is good or bad or whether its satisfaction should be allowed or discouraged. If a thing is capable of satisfying some want it may be said to possess utility, though public policy may decide to limit or disallow its use.

Utilities may be classified—

(i) *Elemental Utility*, e.g. coal still in the seams or unhewn timber.

(ii) *Form Utility*, e.g. coal at the pit-head or hewn timber.

(iii) *Place Utility*—compare the utility of coal in an agricultural and an industrial district, or that of fish at a port and an inland town respectively.

(iv) *Time Utility*—compare the utility of coal in summer and winter, or that of a cup of coffee before and after dinner.

The subject of utility is of first importance in economic theory, and will be considered at greater length in subsequent chapters.

Production and Producers

Production is the creation of utilities. When a chair is produced, the craftsman takes so much wood, screws, etc., which have in themselves relatively little utility, and fashions them into something of greater utility. Those who transport the chair from the factory to the home add a utility of place; the wholesalers, retailers, clerical workers, etc., all have their part in the general process of production.

Instances occur, of course, in which there are too many intermediaries, causing a certain amount of waste. As the organization of industry improves, however, there tends to be less overlapping of effort, and the resultant economy proves advantageous to producers and consumers alike.

Production does not cease, therefore, when the commodity leaves the premises of the actual makers; the process is not complete until the article is in the hands of the consumer Production and consumption are closely inter-connected, and cannot be studied apart.

"Over-production" of a commodity, from the producer's point of view, takes place when the supply is greater than the effective demand and the article can be disposed of only at a loss. It may be caused by faulty organization, or by too optimistic anticipation of the market, or by unavoidable external factors. The notion has been criticized, in that, from the consumer's point of view, over-production is inconceivable so long as any wants remain unsatisfied. This criticism, however, springs from the failure to distinguish between desire and effective demand

Consumption

Consumption is the obverse of production, in that it involves the *destruction*, as opposed to the *creation*, of utilities. The act of consumption may occupy a second or two, or be spread over centuries (*cf.* the consumption of a sweet and of a picture), and applies both to material commodities and to services.

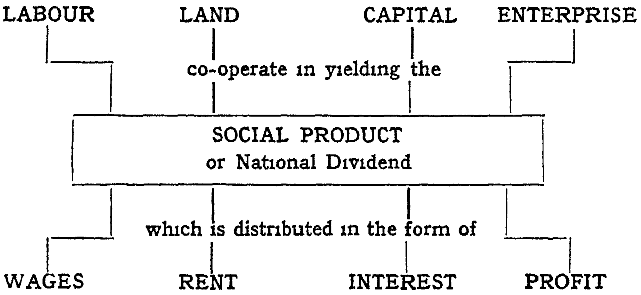
Production and consumption are, in a measure, relative terms, and the one often involves the other. What is the finished article to one group of men may be the material for others; e.g. iron used for making steel, steel for making pen-nibs, nibs "consumed" by the author in producing manuscripts, and so on.

Goods that are consumed in order to produce others are known as *production goods.* Thus the wool or cotton used in making garments, and the machinery employed, come within this category.

Goods that satisfy "final" wants are known as *consumption goods.* Included in this category are not only articles such as clothing, food, flowers, etc., but personal services directly rendered by professional and manual workers, such as doctors or gardeners.

The Factors of Production

In earliest times only two factors were necessary for the production of any commodity, LABOUR and LAND or NATURAL RESOURCES. Production was very simple, no machinery or tools were used, and no long period of waiting elapsed between the first and last stages. As society evolved, man's needs grew more complex and his methods of production became less simple. He began to employ tools, and to set aside some of his product as a reserve or for use, either by himself or later by somebody else, in the production of further wealth. Thus, there developed the employment of CAPITAL as the third factor of production. In time it was realized that a given amount of labour, land and capital might have their collective yield increased if they were co-ordinated and directed under skilled management. This function,



while having much in common with labour, of which it might be considered to be a higher form, became closely associated in practice with Enterprise, which came to be regarded by some economists as a fourth factor of production. Though managerial and entrepreneurial services frequently overlap, the distinction between them is found useful in studying the distribution of the respective forms of income

The Census of Production in the United Kingdom affords information about the value of industrial output and the labour, materials and capital which go to produce it. The following table summarizes the returns for the main industrial groups since the census was first taken. The index of production in recent years is tabulated on p 322, other elements in the national product are considered in Ch VIII.

LABOUR, MATERIALS AND CAPITAL EMPLOYED IN INDUSTRIAL PRODUCTION

	Larger Establishments						All Firms
	Gross Output	Materials and Fuel	Fixed Investment	Net Output	Number Employed	Net Output per Person	Total Employed
	£ mil	£ mil	£ mil	£ mil	Thous'nds	£	Thous'nds
All census industries							
1907	1,765	1,053	—	712	6,984	102	—
1924	3,747	2,106	—	1,548	7,298	212	7,979
1930	3,371	1,789	—	1,504	7,141	211	7,899
1935	3,543	1,841	—	1,640	7,297	225	8,130
1948	12,398	7,098	—	5,039	9,335	540	10,161
1951	18,554	11,504	773	6,601	10,149	646	10,852
1954	20,984	11,902	987	7,949	10,036	789	10,894
1957	24,884	13,916	1,390	9,500	10,153	939	10,804
Manufacturing industries							
1907	1,424	937	—	486	4,951	98	—
1924	3,026	1,857	—	1,076	4,857	222	—
1930	2,677	1,535	—	1,064	4,875	218	—
1935	2,900	1,613	—	1,226	5,376	228	—
1948	10,023	5,995	285	3,766	6,709	561	7,138
1951	15,428	9,969	492	5,045	7,453	677	7,827
1954	17,527	10,168	571	6,163	7,631	808	8,014
1957	20,731	12,061	888	7,285	7,992	948	7,992

CHAPTER II

LABOUR AND POPULATION

The Malthusian Theory of Population

THE supply of labour in general depends, in the first place, on the growth of population, about which there has been much controversy. Over a century ago Thomas Malthus formulated a doctrine which had considerable vogue for a time and in a modified form still has a certain currency. As first expressed, his theory stated that population tends to increase in a *geometric ratio* and to double itself every twenty-five years; e.g. in every successive period population would grow thus: 2, 4, 8, 16, 32, etc. On the other hand, natural supplies of food and other necessaries tend to increase only in an *arithmetic ratio*, e g. 2, 4, 6, 8, 10, etc. According to this view, though everybody, to start with, might have ample supplies and some to spare, the time must come, sooner or later, when the population outgrows the means of subsistence. When, in compliance with this alleged inexorable law of nature, such a stage is reached, population must necessarily be restricted. This is effected by the application of checks by nature, or by man himself, or by both. The *positive* checks imposed by war, famine, disease, etc., cause the death rate to rise. The *preventive* checks, in the form of restraint, late marriages, etc., cause the birth rate to fall. Since nature is apt to be ruthless and indiscriminating in cutting down the population, it behoves man in his own interest to apply his check deliberately and intelligently.

This doctrine, when first enunciated, naturally aroused much criticism, and in the later editions of his work Malthus modified somewhat the dogmatic statement of his theory and practically abandoned the use of mathematical terms. The substance of his main argument, however, underwent comparatively little change.

The Malthusian doctrine influenced economic thought for nearly a century, and did much to earn for economics the name of "the dismal science." Arising out of it, for example, was the "iron law of wages," which stated that any increase in the workers' income must lead inevitably to a growth in population and to keener competition for employment, which in turn must result ultimately in a reduction of the wages to the subsistence level Such conclusions were widely reflected in legislation and industrial policy.

Malthus's theory has lost some of its force First, population does not grow as quickly as he suggested Vital statistics show that the birth rate has diminished from 35 to 15 per thousand during the past half-century, and the death rate from 21 to 13. The *survival rate*, i.e. the excess of the birth over the death rate, has thus dropped from 14 to 2 per thousand

In the second place, the supplies of food and other necessaries have, until lately at any rate, been fairly well maintained. The standard of living of all classes is distinctly higher than it was a century ago.

Thirdly, one should take into account qualitative as well as quantitative changes; there has been, on the whole, a marked improvement in the health and physique of the population.

In recent years, however, misgivings have been expressed by a number of authorities about the world food situation, which is not keeping pace with the growth of population and the demand for higher standards. Abuses such as over-cultivation and soil erosion are largely responsible, over and above the widespread ravages of war.

The modern view of population is less concerned with absolute numbers and more with the relation between the size of the population and the productive efficiency of the community. The *optimum population* is said to be reached when the maximum product per head is attained. The conception, however, has more theoretical than practical significance.

Population and Age Distribution

The growth of the population in this country since the beginning of the century is shown in the following table.

POPULATION OF UNITED KINGDOM, 1901–58
Million

Year	Total	Males	Females
1901 April census	38.2	18.5	19.7
1911 ,, ,,	42.1	20.4	21.7
1921 ,, ,,	44.0	21.0	23.0
1931 ,, ,,	46.0	22.0	24.0
1951 ,, ,,	50.2	24.1	26.1
1952 June estimate	50.4	24.2	26.2
1954 ,, ,,	50.8	24.4	26.4
1956 ,, ,,	51.2	24.7	26.5
1958 ,, ,,	51.7	24.9	26.8

From the standpoint of economic and social welfare the age distribution of a nation can be more important than the total size of its population Advances in living conditions and medical knowledge have reduced the infant mortality rate, thereby countering to some extent the decline in the birth rate, and, at the other end of the scale, have served to prolong the span of life. On balance the average age of the population has been substantially increased.

At the beginning of the century about one-third of the nation's population was under the age of 15 The ratio has since declined to less than one-quarter During the same period the ratio of persons over 64 has increased from one-sixteenth to one-eighth. As is shown in the following table, which is based on estimates of the Government Actuary, the proportion of children under 15 is unlikely to increase as fast as that of persons over 64.

The changes in the age composition has considerable economic significance The increasing number of elderly persons represents a growing proportion of non-producers and a steady rise in the cost of pensions The slower growth in the number of young people affects the flow of entrants into productive employment. These circumstances underline the necessity for reducing the rate of infant mortality still further and promoting the health and capacity of the working population as a whole. They point no less to the imperative need for making the most efficient use of labour supplies and taking full advantage of modern science and technology Much progress has been made in these various directions, but there is still great scope for further improvement

ESTIMATED FUTURE AGE DISTRIBUTION IN UNITED KINGDOM
1963–1993[1]

Year	Total Population	Under 15	Per cent of Total	Over 64	Per cent of Total
	Million	Million	%	Million	%
1963	52 9	12 0	23	6 4	12
1973	55·1	12 6	23	7 6	14
1983	57 0	13 0	23	8 3	15
1993	58 8	13·3	23	8 3	15

[1] Adapted from *Annual Abstract of Statistics*, 1959

The Efficiency of Labour

Labour denotes all economic effort, mental and manual, that is devoted to the production of wealth, i.e. to the creation of utilities of one kind or another. Effort expended purely for the sake of pleasure, such as activity in games, is excluded from the definition, for it is impelled by no specific economic motive.

The efficiency of labour depends on the following factors—

(i) Peculiarities of stock and breeding, which depend partly on climate and environment

(ii) Educational standards and facilities for training.

(iii) Method and amount of remuneration An advance in wages may provide a greater incentive, or in some cases the physical opportunity, for more intensive or sustained effort

(iii) Hours and working conditions A reduction in working time, if it reduces fatigue and especially if it is accompanied by improved methods and techniques, need not imply a reduction in specific output.

(iv) Management and organization at all levels

Thus the efficiency of the worker depends not only on his own qualities, and efforts, but also on a number of external conditions over which, as an individual, he has little or no control.

Mobility of Labour

The ease or difficulty with which labour can "flow" from one direction to another is of great practical importance. The mobility of labour may take a number of forms—

(i) *Economic Mobility*

(*a*) Lateral, as between one employment and another, but still performing the same task, e g. a typist moving from a textile to an engineering office.

(*b*) Vertical, as between employments of different kinds; e.g. a typist becoming a milliner.

(ii) *Geographical Mobility*, i e. from place to place Home ties, sentiment, ignorance of better conditions elsewhere, the difficulty of finding a house in a new locality, the cost of moving, all tend to impede free movement.

(iii) *Social Mobility* Certain professions, e g law and medicine, are difficult to enter owing to social and wealth barriers; in some industries trade union restrictions serve as a bar.

Correctives to Immobility

Normal economic forces can usually be depended upon, over a period, to bring about a redistribution of labour. For instance, high wages in one industry or locality may be a sufficient inducement to secure a required flow of workers Similarly, the breakdown and simplification of operations and the extension of automatic machinery facilitate the movement of labour from one type of employment to another

The factors making for immobility, however, are often too powerful to be overcome in such ways, and may result in "pockets" of unemployment at the same time as there is a shortage of workers elsewhere. Hence schemes may be adopted either to encourage a transfer of labour, or, because of the social difficulties which this transfer entails, to establish new means of employment where the labour is available. Thus, training schemes and maintenance may be provided, coupled, where necessary, with grants towards the cost of removal and resettlement. To induce industrialists to start production in depressed or newly developing areas, factory space or buildings may be offered at low subsidized rentals.[1] To deal with a particular cause of immobility, arising from private pension funds which tend to inhibit employees, including highly-paid executives, from going elsewhere for fear of losing their benefits, broader-based schemes may be introduced so as to permit of transfer of employment without sacrifice of rights

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[1] Facilities of this kind have lately been provided in Merseyside, Clydeside, South Wales, Northern Ireland, etc

CHAPTER III

LAND AND CAPITAL

Land

"LAND" is the term used in economics to denote the materials and forces supplied by nature for use in production. It covers not only land, as usually understood, but such materials as minerals, timber, brine and gases, and natural forces like tides, winds, and sunlight In what follows, however, the term will be used in its ordinary sense, unless stated to the contrary.

The productivity of land depends on—

(i) *Physical conditions*, such as fertility of soil, latitude, climate, mineral wealth, etc. Included under this head is the geographical position in relation to markets.

(ii) *Economic application.* The yield may be improved through artificial manures, or irrigation, or even modification of climatic conditions. Also improvements in transport and communication may bring a place nearer, as it were, to the market, and so increase the net return.

Systems of Land Tenure

(i) *Landlord and Tenant-farmer*—the system usually found in Great Britain. Land is let and sublet on long or short leases. The money rent is fixed for a period by agreement.

(ii) *Peasant Proprietorship and Cottier Tenure*—common in Belgium, France, and elsewhere. In France about 40 per cent of the people are directly dependent on the land, and most of these are peasant proprietors.

(iii) *Métayer System*—to be found in Southern Europe. Here the landlord lends some capital with the land, and receives a return proportionate to the produce

(iv) *Ryot Tenure*—as in India. In this system the owner-cultivator pays a fixed proportion of the produce to the Government.

(v) *Collective Ownership and Cultivation*—as in the Soviet Union and China

Methods of Land Cultivation. Farming is said to be *extensive* when the cultivator works over a comparatively large area, as in the new countries, finding it more profitable to cover a wide territory than to try and get every possible pound of produce from a more limited area.

In thickly-populated countries, where land costs more, farming tends to become *intensive.* The limited tracts of land are usually worked more thoroughly and scientifically so as to obtain a higher yield per acre.

Extensive farming is not necessarily the same as large-scale farming, nor intensive necessarily the same as small-scale farming. More capital may be invested in the intensive cultivation of a small area than in the working of a large area of land.

Peculiarities of Land

Land is strictly limited in quantity. It is different from the other factors of production in that, for practical purposes, it is permanently in being; no change in demand can affect the amount of land in existence.

But, though the area of land is fixed, its services as a factor of production have been greatly increased. Fertilizers have added to the quality and quantity of output; improvements in transport have made available certain regions whose products were not formerly available.

Thus, land in the everyday sense of the term may be classified as follows—

(*a*) Land which possesses only natural or original powers of production (e g virgin land in a "new" country, not requiring any preliminary clearing). In an "old" country very little of this land is to be found.

(*b*) Land which possesses in addition the powers of production that have been added to the elementary qualities (e.g. by fertilizers, clearing of ground, improved transport, etc.).

(*c*) Land which possesses situational advantages Pressure of a growing population gives a value to certain areas considerably in excess of their "fertility" value (e g sites in or near centres of population).

The Nature of Capital

Capital is wealth set aside for the production of further wealth. It represents a stock or fund of wealth at a particular time, as distinct from income which is of the nature of a flow over a period. In a previous chapter it was noted that, in early times, when one lived from hand to mouth, capital was comparatively unimportant. Labour was direct and for the satisfaction usually of one's own needs. With the growing demand for, and variety of, goods, production became more indirect and drawn-out, and involved the ever-increasing use of capital in such forms as tools, machinery, and stocks.

While capital is necessarily wealth, wealth is not necessarily capital. Thus, a tennis racquet would be capital only if it were used by a professional player in earning an income; if used simply for the purpose of enjoying the game it would be a form of wealth, but not capital in the strict sense. Some economists, however, consider such goods to be "consumer's capital," on the ground that they yield a flow of services or real income.

Theoretically land is a primary or natural factor while capital is a secondary or produced factor. This distinction however, tends to be blurred for the reason that land is commonly improved by capital investment on clearing, draining, fertilizing, etc., with the result that land in the primary sense becomes the exception and not the rule. Even if it were desirable to separate the natural from the man-made factors, it would usually be impracticable to do so.

Natural and Acquired Characteristics

To avoid confusion it is necessary to draw a distinction between two conceptions of capital—

(i) **Capital as an agent of production.** This may be called its *natural characteristic* Capital in this primary sense is indispensable in any form of industrial organization, whether under private or public enterprise. Socialists do not dispute the importance of capital as a material requisite of production. Their objection is really to capitalism as implied in the second conception—

(ii) **Capital as a source of income without direct effort.** This may be termed its *acquired characteristic*, to which fuller reference is made below.

Types of Capital

The different ways of classifying capital are set out below. It should be borne in mind that the classes are not mutually exclusive of each other, and that a particular form of capital goods may belong to more than one category.

Social and Individual. Capital is regarded in its social aspect when it functions as an agent of production It is viewed in its individual aspect when it functions as a source of income, irrespective of the use made of the wealth. A person may draw interest from the loan of his wealth, though the latter may not be employed in furthering production.

Fixed and Circulating. Fixed capital is that which exists in durable shape, and is used repeatedly, e g machinery, ships, office furniture.

Circulating capital is that which fulfils its function in one use; e g. nails, seeds, writing paper.

Sunk and Floating. Capital is "sunk" when it is highly specialized in form, and cannot be adapted to other use, e g power loom, pit-shaft.

Floating capital is that which is not specialized, and can be employed in different uses, e g. money, coal

Material and Personal. Material capital is that which has a concrete form, and of which the ownership is transferable; e g. a singer's piano

Personal capital, on the other hand, is the purely personal ability, in the training of which some wealth may have been invested, e g a singer's voice

Remuneratory and Auxiliary. Remuneratory capital is that used for paying wages and salaries.

Auxiliary capital is that devoted to machinery, material, etc. Different occupations involve different proportions of each, *cf.* the capital costs of a professional man and a manufacturer.

Formation of Capital

The formation of capital depends on both the power and the will to save.

The *power to save* is governed largely by the capacity to produce wealth in excess of immediately necessary consumption; also by the efficiency of the joint-stock and banking systems for collecting relatively small amounts of wealth, and putting the total to more productive use.

The *will to save* is influenced by the amount of preference for future over present satisfactions, by the desire to provide for oneself and dependants, by the anticipated revenue from savings, and by the prevailing condition and security of the times.

Saving, as viewed by the individual, involves the abstention from consumption. From the standpoint of the community it usually means the transference from one person who could put the wealth to comparatively little, to another person who puts it to greater, economic use "Over-saving" is said to take place when an excessive amount of current income is applied to the provision of capital goods, or is hoarded, leaving insufficient spending power with consumers to acquire the products made available.

The ratio of total investment to the national income of the United Kingdom was about 17 per cent in 1948, rising to about 20 per cent in 1958 The growth and financing of investment during this period is shown in the following table. The important role of companies and public bodies in the formation of capital is clearly brought out [1]

GROWTH AND FINANCING OF INVESTMENT[2]

£ million

	Total	Personal Sector	Companies	Public Corporations	Central Government	Local Authorities
1948	1,772	− 48	888	41	731	102
1949	1,860	30	750	131	793	126
1950	1,953	36	957	101	734	96
1951	2,112	32	1,173	96	633	95
1952	2,408	538	966	195	451	98
1953	2,688	616	1,247	206	293	144
1954	2,839	448	1,565	201	298	146
1955	3,068	726	1,584	157	510	128
1956	3,649	1,099	1,755	212	424	150
1957	4,023	1,202	1,794	169	615	186
1958	4,004	1,231	1,709	182	649	173

Characteristics of Capitalism

The employment of capital gives production a "roundabout" character; i e wealth is not consumed directly for its own utility, but is employed as an instrument for producing "final utilities" at a later stage. Usually the scale and the duration of the productive process are increased

The private ownership of capital confers the power of employing other people, directly in one's own business or indirectly by the ownership of shares in joint-stock companies, and thus of obtaining profits which are the result of this privileged position. Hence it is opposed by extreme Socialists who desire the nationalization of the instruments of production. Public ownership of capital, however, without other important changes, would be unlikely to yield the results desired by these critics, for there is more in capitalism than simply the private ownership of the means of production.

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[1] Saving and investment are considered more fully in pp 267–9 and 340–1

[2] *National Income and Expenditure*, 1959 The table excludes tax and dividend reserves

The characteristics of capitalism may be summarized—

(i) *The institution of private property.* It is taken for granted in capitalist society that individuals may own property and do with it what they like, provided that its method of use is not in conflict with the public interests. An owner of property may use it himself, or hire it out to somebody else, or refrain from putting it to any use at all

(ii) *The institution of free enterprise.* A person may undertake any economic activity he chooses, again subject to the above over-riding conditions. He may make what he wants and sell it how and for what he likes It will be shown in later chapters that individual freedom of action in economic affairs has in recent years been somewhat curtailed, partly because of the restrictive practices of private monopolies, partly by the growth of public monopolies and the extension of public regulation over a wide field.

(iii) *The institution of consumer's free choice.* This is closely bound up with the two foregoing conditions, and indeed is a necessary complement to them. Most production in modern times is undertaken in anticipation of the demand, and ultimately must be ruled by it. This is not to say, however, that the consumer has absolute or sovereign power, any more than that he is always right.

The State imposes restrictions on certain forms of consumption just as it interferes with certain types of production. The power of the monopolist, further, may be too strong for effective consumer's resistance, while high-power advertising and salesmanship also tend to restrict free and independent choice.

(iv) *The institution of the price system.* The nature and operation of the price system will be explained in Part II. Meanwhile it is sufficient to say that the free price mechanism is an integral part of the capitalist system. If supplies are short prices tend to rise and thus stimulate production and discourage consumption. If there is a glut, prices tend to fall, production to diminish, and consumption to increase. The level of prices serves as a guide to producers and consumers alike, subject always to the growing intervention of the State in the regulation of prices, in discriminatory commodity taxation and subsidies, and the like.

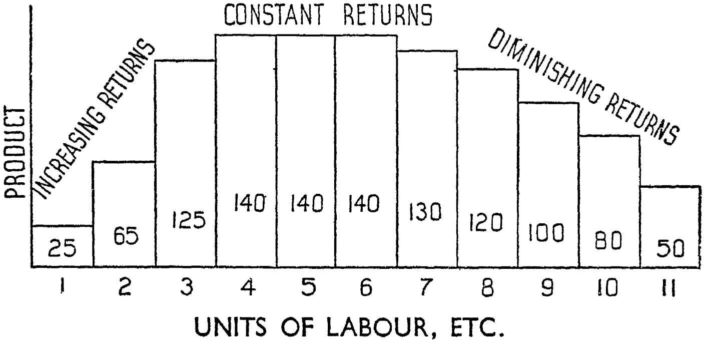
The Laws of Non-proportional Returns

Whether under private or public enterprise, the system of production is subject to the laws of diminishing and increasing returns.

Diminishing Returns. The Law of Diminishing Returns states that, **after a certain point, an increase in the capital and labour applied in production causes a less than proportionate increase in the amount of the product.**

It may be otherwise stated as the Law of Increasing Costs per unit produced.

The application of the law to the cultivation of land may be considered first, though, as will be shown later, it is of significance also in manufacturing industry. Suppose that a farmer is employing successive units of labour and capital in the working of his land. For simplicity, assume that each unit is represented by one man. After a certain point in the application of successive "doses," the farmer will find (assuming that no new methods, mechanical or chemical, are introduced) that the additional yield for each man employed begins to decline. For instance, the return from the employment of successive men may increase in the early stages, but the yield from (say) the seventh man may be (say) 130 bushels compared with 140 bushels from the sixth man. In other words the farmer



is experiencing a diminishing return, but he will not necessarily cease operations as soon as the additional yield per dose begins to decline He will stop applying capital and labour only when the return falls below the minimum which it is considered worth while to produce (See illustration above.)

It is essential to note that the doses of capital and labour which yield diminishing returns need not necessarily be *consecutive* in order of application. They may be applied *simultaneously*, and still show the same result. Thus, a given quantity of capital and labour applied to a field every day for a week may yield a smaller extra return for the sixth application than for the fifth. Similarly, six units of capital and labour applied *at a* *time* may not yield six times as much as if only one unit were applied. A farmer taking on men may find that the extra product due to the tenth worker employed is less than that obtained from the addition of the ninth man, though the men are all working together and their efforts and abilities are of the same grade. Diminishing returns, therefore, are not necessarily a matter of time.

Increasing Returns. The Law of Increasing Returns (or Diminishing Costs) is said to operate where **an increase in the capital and labour applied in production leads to a more than proportionate increase in the amount of the product.**

It was observed in the above example that additional output per man began to fall off after the sixth "dose." In the earlier stages, however, the output per man may have increased. For instance, the first man, working alone, may have produced only 25 bushels; the second 65, bringing the total to 90; the third 125, bringing the total to 215, and so on. Under such conditions the farmer is experiencing increasing returns.

The rate of yield to additional doses does not necessarily rise to a peak and then immediately decline. When the maximum yield has been reached it may continue for a number of doses. At this stage the opposing tendencies to diminishing and increasing returns balance each other, and the farmer experiences **constant returns.**

Varying Marginal and Average Returns. The same conditions may be re-classified so as to bring out not only the varying *marginal* returns but also the varying *average* returns. In the table opposite it is shown that marginal returns begin to decline with the employment of the seventh man, average returns do not diminish until the ninth man is reached

It should be realized that *the laws of non-proportional* *returns refer to the quantity, and not necessarily to the value, of the product.* A farmer may experience a falling-off in the amount of his additional produce, but nevertheless, if the price is high, find it to his advantage to increase his outlay. On the other hand, a producer may find that the economies of producing on a larger scale are liable to be offset by the decline in market prices following increased supplies.

MARGINAL AND AVERAGE PRODUCTIVITY

No. of Men	Marginal Product	Total Product	Average Product
1	25	25	25
2	65	90	45
3	125	215	72
4	140	355	89
5	140	495	99
6	140	635	106
7	130	765	109
8	120	885	111
9	100	985	109
10	80	1065	106
11	50	1115	101

The Laws of Returns in Extractive and Constructive Industries

In agriculture, particularly, is the law of diminishing returns in evidence, since the amount of land available is comparatively fixed. Although as a result of modern methods of fertilization, scientific rotation, and improvements generally, the operation of the law is less effective than at the time when Malthus wrote, and indeed seems at times to have been counteracted, its recurring threat cannot be disregarded.

In constructive industry, on the other hand, the producer has more scope. His resources are not so limited in supply and, by a proper arrangement of the labour and capital goods at his disposal, he can better enjoy the benefits of increasing returns. To turn out but a few motor-cars, for example, would, in view of the heavy preliminary and overhead expenses, entail a high unit cost, but, as the number of cars in production increased, the cost of each would greatly diminish.

An increase in the *size* of a producing unit does not necessarily result in a reduction in costs, apart from the possible saving in overhead charges. No less important is the economy effected by an increase in the *scale* of production, i.e. in the intensity with which the resources, both labour and material, are employed The significance of size and scale is more fully considered in Chapter IV, Section 2.

The co-ordination and selection of the different factors of production, in such proportions as to get the maximum return, is in accordance with the principle of substitution,[1] which applies to all spheres of economic production and consumption.

It may be stated as a general rule that diminishing returns are more common in such extractive industries as agriculture, mining and fishing, and that increasing returns are characteristic of constructive manufacturing industries.[2] After a certain point, however, irrespective of the industry, the tendency to diminishing returns is liable to show itself, and man therefore has constantly to use his inventiveness and ingenuity to overcome it.

The practical significance of these laws may be illustrated by a couple of examples—

If a firm is producing under conditions of increasing returns, it may be profitable to spend money on advertising and create an extra demand, and increase the output at a diminishing unit cost The outlay on advertising under such conditions need not entail an addition to the price, and might in fact bring about a reduction On the other hand, extensive advertisement of an article produced under diminishing returns might so raise costs as to inflict a loss on the seller and public alike.

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[1] See pp 76-7 and 83-7

[2] See p 38

The size of a business depends to a great extent on the nature of the returns. Since the large farmer, in competition with the small farmer, reaches diminishing returns at a relatively earlier point than the large manufacturer in competition with the small manufacturer—in other words, as the manufacturer is better able to secure the economies of large-scale enterprise—it is more difficult to squeeze out the small farmer than the small manufacturer. Thus the tendency is for large-scale production to be more usual in manufacture than in agriculture, and for the small producer to be more common in agriculture than in manufacture.

CHAPTER IV

ORGANIZATION AND ENTERPRISE

Section 1. *The Division of Labour*

Occupational Groupings

ONE of the chief characteristics of modern economic organization is to be found in the division of labour. This involves the specialization of labour-power, both among groups and individuals, in such a way that the output is greater than would otherwise be possible. In primitive times there was little or no specialization beyond the apportionment of heavy and light duties among the strong and the weak. As communities developed, the division of functions among various groups evolved more or less spontaneously, and in the course of time individual tasks became increasingly subdivided

The occupational groupings may be roughly classified as follows:

(i) **Extractive**—
  (*a*) Exploitative, e.g mining;
  (*b*) Genetic, e g. agriculture.

(ii) **Constructive**; i.e. manufacturing and making up into finished articles.

(iii) **Commercial**—
  (*a*) Distributive; e.g. shopkeepers, travellers;
  (*b*) Transport; e.g. railway services;
  (*c*) Banking, insurance, and other financial services.

(iv) **Direct and Public Services**; e.g. the professional activities of a lawyer or musician, or the services of a publicly employed teacher or official.

Originally, even this elementary type of specialization was not much in evidence Men were practically self-sufficing. When the division of labour developed among individuals, districts, and finally among nations, these groupings became more defined. Little over a century ago Great Britain, like other countries, was primarily extractive. To-day such interests are overshadowed by the constructive and the commercial. It is the "new" countries that are mainly extractive, providing the "old" countries largely with food and raw materials.

Division of Labour

Division of labour, in addition to the wider groupings indicated above, takes the following forms—

(i) *Division into whole industries and callings*; e.g. wool textiles, mining, teaching. This is a form of division of labour so primary that it is often overlooked.

(ii) *Division of these occupations into groups of complete processes*, e g. the wool industry into sheep-rearing, spinning, weaving, dyeing, merchanting.

(iii) *Division of these processes into part-processes* Further specialization occurs as between the "woollen" or "worsted" sections Within the factory, subdivision grows more intense.

Advantages. The advantages of the division of labour may be shortly summarized—

(i) **Accruing to industry generally**—

(*a*) Increased output.

(*b*) Superior quality of work, as a rule.

(*c*) Saving of time in workshops.

(*d*) Increased use of machinery.

(*e*) Economical use of machinery·

1. A complete set of tools is no longer necessary for each worker.

2. Delicate and expensive equipment is entrusted only to skilled men.

(*f*) Increased scope for inventions and new appliances (as distinct from greater inventiveness on the part of the worker himself, who may in fact have his senses dulled rather than sharpened by the mechanical routine).

(*g*) Local supply of specialized labour, accompanying the localization of industry.

(ii) **Accruing to the worker—**

(*a*) Increase of dexterity and skill through constant repetition.

(*b*) Saving of time in learning a trade.

(*c*) Diminution of physical strain (except where the tempo of operation, and possibly the speed of the machine, is too high).

Disadvantages. These fall mainly on the worker, but are liable indirectly to affect the whole of industry.

(*a*) Monotony and narrowing influence of the work.

(*b*) Immobility of labour.

Occasionally, however, the subdivided processes of one industry may resemble those of another (e.g. wool-spinning and cotton-spinning, or processes common to the making of watches and precision instruments), facilitating a flow of labour from one employment to another

(*c*) Loss of sense of responsibility.

(*d*) Limitations arising from the use of machinery. (See below)

(*e*) Drawbacks of factory-life and overcrowded towns.

(*f*) Where the organization is on a large scale, the loss of personal relationship between employer and employed.

(*g*) Where the industry is highly localized, the liability for unemployment during depression to become cumulative and especially severe.

Limits. It is not economic to carry specialization to an advanced degree—

(*a*) Where the demand for the product is very limited;

(*b*) Where the market is such that an increase in supply causes a considerable fall in price; and (*c*) Where diminishing returns are experienced at a comparatively early stage.

Benefits and Limitations of Machinery

The advantages and disadvantages of machinery are closely bound up with those of division of labour.

(i) **Advantages**

(*a*) Machinery relieves man of many heavy duties, some of which would be too burdensome for him working alone.

(*b*) It reduces the amount of drudgery by taking over monotonous repetitive tasks (though monotony is created in other directions).

(*c*) Machinery works more quickly, and so yields a greater output.

(*d*) Machinery is more accurate and regular.

(*e*) Standardization is made possible.

(*f*) Goods are produced more cheaply.

(ii) **Limitations.** Certain of the following drawbacks are inevitable, though there are some compensations.

(*a*) Skilled craftsmen are frequently reduced to, or replaced by, semi-skilled machine operators. (The operation of certain types of machinery, however, calls for special skill of a high order.)

(*b*) Hand-work is frequently superior to, and more artistic than, machine-work. (This, however, is not always true, and where accuracy is called for the machine may have the advantage.)

(*c*) Where a man has to keep pace with a fast-working machine, there is a certain amount of strain.

(*d*) The introduction of machinery is commonly stated to be a cause of unemployment Though it may displace labour in a short period, machinery in the long run may increase output, reduce prices, and stimulate further demand. The problem of unemployment, and the responsibility of machinery, are considered more fully later.[1]

Localization of Industry

Specialization by area is, in a sense, a form of division of labour. It arises from—

(*a*) Physical and climatic conditions; e g mineral resources and natural transport facilities such as navigable rivers

(*b*) Arbitrary and semi-political reasons; e.g. the settlement in certain localities of foreign refugee craftsmen, such as the Flemings and Huguenots.

(*c*) Adaptation of means of transport and communication.

(*d*) Specialization of labour and capital.

(*e*) Rise of subsidiary industries and services.

(*f*) "Industrial inertia." An industry may continue in a particular district long after the original cause has disappeared. The Potteries, for example, no longer depend mainly on local clay, nor the West Riding on local wool supplies. It is often more economic to bring the materials to the areas where the industry and attendant services have been developed than to start anew nearer to the source of supplies.

Delocalization. Of late there have been certain forces in operation that tend to restrain the movement to further localization, and in some cases have resulted in a degree of delocalization

(*a*) The increased use of electrical power, and its economical transmission, compared with steam or other forms of power, over long distances.

(*b*) Developments in road and other transport.

(*c*) Improved organization for collection and distribution of goods, and for the financial operations involved.

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[1] See pp 143–5.

(*d*) The lower rent and rates in comparatively undeveloped areas away from thickly populated centres.

(*e*) The diminishing reliance on special skill ordinarily associated with particular localities, as the industry becomes more mechanized.

(*f*) State encouragement to new ventures in "development areas," in order to secure a healthier distribution of industry and employment

(*g*) Creation of new towns and expansion of existing smaller centres in order to divert population from unduly large and overcrowded cities

Section 2. Economic Organization

Organization and the Entrepreneur

The function of organization is not so easily definable as are the agencies of production previously discussed, and it is a matter of opinion whether it should be considered as being allied to labour rather than as an independent factor in itself But, however regarded, its place in modern industry and commerce is so important as to demand separate treatment

Enterprise may, for practical purposes, be studied in conjunction with organization Most production is now carried on in anticipation of demand, and success or failure depends largely on the ability of the **Entrepreneur.** The ideal entrepreneur is he who, apart from the necessary technical ability, possesses foresight, the power of judgment, the knowledge when to take risks, and the capacity to lead men and inspire confidence.

The theoretical difference in function between the entrepreneur and the capitalist should be noted. The former, in the strict sense, is concerned with the taking of risks, the latter with the investment of capital. In practice, however, it is difficult often to draw a clear distinction, for a capitalist necessarily undertakes a certain amount of risk, while the entrepreneur, as a rule, invests some capital. Also, under the modern system of capitalizing industry, the risks are commonly spread over a large number of persons. It is best, therefore, to regard this form of enterprise as a function in which many may participate rather than as the exclusive contribution of a particular type of person.

The decisions which the entrepreneur has to take differ naturally from one industry to another, but the following are typical problems that he has to face—

(i) The nature of the production or service he will undertake. As a rule he will enter the industry of which he has some experience, but if he possesses the entrepreneurial qualities in a high degree he will not be limited to this industry.

(ii) The size of the firm and of the production unit. While these usually vary together, it may happen, as previously noted, that the production is most economically carried on in a number of units, each of the optimum size. It is the function of the entrepreneur to determine the extent of each unit, the nature of the plant, and the degree of any decentralization that may be necessary.

(iii) The location of the firm. In deciding on this (which includes the location of any branches) the entrepreneur will take into account the proximity on the one hand to raw materials, power, and skilled labour, and on the other hand to markets and customers. Transport costs, local rates, etc., will also be determining factors. With the evolution of automatic machinery which can be tended by semi-skilled labour, the growth of electrical power and the diminishing dependence on coal, together with the considerable advances in road and other transport which supplement the older railway systems, the entrepreneur of to-day has a wider choice than formerly in settling upon his centre of activity.

The Size of a Business

The entrepreneur naturally finds the greatest opportunity where production is conducted on a large scale. While this is the rule in modern society, the small-scale firm still survives and even flourishes in certain industries. It may be roughly generalized that the large firm tends to be the rule in the constructive industries, and that the small firm retains a hold in the extractive industries and in the retail trades. Important exceptions, however, are to be found. There are many prosperous small concerns in manufacture, while, especially in the "new" countries, farming and other extractive operations are conducted on a large scale In the retail trades, too, the position of the independent shopkeeper is being increasingly threatened by the multiple firms, which may have a large central organization, enjoying the advantages of buying in bulk and in some cases producing in their own factories, and distribute their wares through a chain of stores throughout the country.

The size of a business is largely determined by—

(i) The nature of the industry. In extractive industries diminishing returns tend to appear at an earlier stage, thus limiting the profitable extension of the business.

(ii) The nature of the market. If the demand is seasonal or spasmodic, or subject to serious fluctuation, there may be little opportunity for successful expansion.

(iii) The extent to which certain of the factors in a business are "indivisible." Thus, for example, the heavy presses employed in making motor-car bodies must of necessity be of a minimum size, and their cost would be prohibitive to any except the very large firms.

(iv) The extent to which the success of the business depends on the maintenance of personal relations between the principal parties.

(v) The ability and enterprise of the employer.

(vi) The amount of capital available for further development.

The Optimum Unit

The unit of production is said to be at its optimum size when the costs are at the minimum. It may, of course, grow beyond this size—and commonly does—but the advantages are not in proportion unless the organization comprises two or more complete units. Hence it is necessary to distinguish between the optimum size of the producing unit and that of the firm as a whole The firm may derive commercial and financial advantages, both in its buying and selling departments, over and above the economies of full scale production It may be found expedient and profitable to decentralize actual production, provided that the operating units are of adequate size, while retaining centralized control and administration.

The actual size of the optimum producing unit varies considerably from one industry to another, depending largely on the nature of the work and of the capital equipment. In a trade which calls for individual skill and relatively little machinery (as in bespoke tailoring) the optimum unit tends to be small; where the processes are highly subdivided and mechanized (as in motor-car production) the optimum tends to be large.

The ratios of capital to labour costs differ greatly, and the optimum, reckoned in terms of either, varies accordingly. In a modern paper mill, for instance, a few large machines may yield a prodigious output, but require a relatively small number of operatives, perhaps only a hundred or so in all. A shoe factory is also highly mechanized, but here the machines are of modest size and much more numerous, calling for a correspondingly larger number of workpeople Even so a labour force of two or three hundred, varying according to the type of shoe produced, may be sufficient to provide full technical economies, as distinct from additional commercial and administrative economies which the larger concern may enjoy.

Advantages and Disadvantages of Large- and Small-scale Production

The benefits and drawbacks of large- and small-scale production respectively may be summarized—

(i) **Advantages of Large-scale Production.**

(*a*) Economies of large purchases and sales

(*b*) Advantages of intensive division of labour, previously enumerated.

(*c*) Continuity of operations from one stage to another.

(*d*) Economy of material and power.

(*e*) Utilization of by-products.

(*f*) Overhead charges (e.g. rates, insurance) spread over large volume of business.

(*g*) Power to spend money on advertising, experiment, and research.

(*h*) Greater ability to cope with trade fluctuations.

These benefits may be described as *internal economies*, for the reason that they are planned and controlled within a firm's own organization. *External economies*, on the other hand, are those which are available for the industry as a whole, not necessarily at the instigation or for the special benefit of any particular firm. Thus, research institutions, technical colleges, transport facilities, etc., are at the service of all firms, large and small.

Though large-scale production and mass production have much in common, they are not necessarily the same. The former simply denotes that operations are conducted on a large scale without reference specifically to the manner of production. The latter usually implies the fabrication of standardized products and the reduction of individuality or variety to the minimum Large-scale firms can turn out individual products Firms that employ mass-production methods are usually large in extent, but it is possible for standardization to be undertaken in comparatively small establishments.

(ii) **Advantages of Small-scale Production.**

Small-scale organization is usually associated with the one-man business or the partnership, though a large proportion of company undertakings, especially private companies, are also of modest dimensions. The chief advantages of the small firm are—

(*a*) Personal interest and supervision.

(*b*) Greater regard for detail.

(*c*) Greater adaptability to changing conditions.

(*d*) Knowledge of customers and ability to suit individual needs, especially where the market is small and specialized.

(*e*) Direct contact between employer and employed.

(iii) The **Drawbacks** of the one are, of course, implied by the advantages of the other, but the following special disadvantages of large-scale enterprise may be added—

(*a*) A highly-specialized large concern finds more difficulty than a small firm in changing the nature of its structure, or the direction of its effort, to meet altered circumstances.

(*b*) When a breakdown occurs in a large organization the resultant cost and dislocation can be especially severe.

(*c*) The failure of large businesses often involves many other firms and may cause widespread losses.

Joint-stock Enterprise

The principle of joint-stock was understood and practised in the sixteenth century and even before, but it was not until the nineteenth century that company formation became widely established

Before the Industrial Revolution there was comparatively little need for large amounts of capital Production was simple, and long periods of waiting rarely elapsed between the first stages of production and the sale of the commodity Agriculture, which was then the main occupation of the people, required little financial outlay. What money was required could, as a rule, be supplied by one man or a small partnership.

After the Industrial Revolution heavier capital investment became indispensable, and it was found increasingly difficult to find small groups of men who were able or willing to lay down the necessary sums. Without the agency of the joint-stock company the construction of the canals and, later, the railways, would have been seriously impeded.

A drawback of early joint-stock organization was that the liability of the shareholder was unlimited, and there was the danger, about the middle of the nineteenth century, that the supply of capital would run short of the demand. The difficulty was overcome by legislation, which established the principle of *limited liability*, according to which the liability of an individual shareholder was limited to that part, if any, of his holding which was not paid up. This assurance to investors was followed by a rapid development in company formation

The following table gives some indication of the extent of company organization in recent years Public companies account for about two-thirds of the total share capital, though private companies are thirty times as numerous, and have doubled in number in the past twenty years.

JOINT STOCK COMPANIES[1]

	Number		Paid-up Share Capital £ million	
	Public	Private	Public	Private
1938 .	14,483	144,846	4,117	1,919
1948	12,988	228,140	3,906	2,071
1953	11,553	261,981	4,088	2,391
1958 .	11,035	322,490	4,649	2,678

[1] Board of Trade

Co-operative Organization

An important feature in modern industrial and distributive organization is the co-operative society, which is to be found in practically all parts of this country. Though the consumers' society is the best known, other forms of co-operative activity should be distinguished—

(i) **Producers' Societies.** In the earliest days of the movement, co-operation was chiefly confined to organizations of producers. Working men subscribed some capital between them, or obtained it from wealthier sympathizers, and combined to produce commodities, the profits from which were distributed in some agreed proportions among the members of the society. The ventures were self-governing, and were carried on alongside and in competition with ordinary capitalistic concerns After the first enthusiasm, however, most of the societies of producers in this country disappeared. On the Continent they had greater success, but in Great Britain they failed to obtain a solid foothold. In certain industries, notably in the boot and shoe, textile and printing trades, there are still a few flourishing producers' societies, but, regarded in general, the experiment has had but a limited success.

(ii) **Agricultural Societies.** In some countries, for example Denmark and Ireland, co-operation has made some progress with agriculturists, particularly in the provision of credit, the use of appliances, and the marketing of produce. Up to a point such corporate activity might be regarded as a form of producers' co-operation. There are, however, important differences In the first place, the co-operation frequently does not begin until comparatively late in the productive process, the farmers being left to cultivate their land or raise their stock in their own fashion and without restrictions Secondly, and a more vital difference from the standpoint of labour organization, agricultural societies are ordinarily composed of farmer-employers whose motives for combined action have little in common with those inspiring labour self-government. Indeed, where the co-operation takes the form of fixing prices above the level possible under competition, the policy may be inimical to the interests of the workers in general.

(iii) **Co-operative Credit Societies.** Largely, but not exclusively, in connection with the agricultural societies, are co-operative organizations for the advancing of loans to members The pooling of resources in this way is of considerable value to small producers especially.

Consumers' Societies

Following the several experiments conducted by the producers' societies, co-operators gradually turned their attention, from the 'forties onwards, to the less ambitious, but much more successful, method of corporate trading Goods were bought collectively at wholesale prices, and the ordinary trading profits were thus retained by the members of the society. The new form of co-operation made a wide appeal, and societies sprang up all over the country, especially in the industrial areas.

The next stage in the evolution of the British co-operative movement was the decision to engage in some of the simpler forms of production under the control of consumers' organizations. Numerous societies began to make their own bread and other necessaries. A more important step was taken in the 'sixties, when the English and the Scottish Co-operative Wholesale Societies were established for the purpose of producing and merchanting on a large scale and furnishing the co-operative stores with as large a proportion of their requirements as possible. The new venture was enormously successful, and the wholesale societies now supply from their own factories and fields three-quarters of the goods bought in the retail stores.

Though production is now an important co-operative activity, it should be distinguished from that envisaged by the self-governing producers' societies. The employees in the C.W.S. factories are in some ways better off than in ordinary concerns, but essentially their position is the same. They are paid on a wage basis, and the control comes almost entirely from the consumers.

The wholesale societies bear a similar relation to the retail societies as do the latter to the individual members The profits of the C.W.S. are distributed among the local societies in proportion to purchases, and are in a like manner passed on to the members. The control is from the consuming, not the producing, end.

In 1959 the consumers' movement comprised about 1000 societies and a membership in excess of 12 million. Since one member commonly represents a whole family, the number of persons provided for is considerably greater. It is estimated that the societies supply approximately one-half of the population with about one-half of their foodstuffs and one-tenth of their other household requirements

The Census of Distribution for 1957 revealed important changes in the pattern of retail trade and in the relative position of the co-operative societies. These changes are summarized in the tables below and overleaf

The Co-operative Society and the Joint-stock Firm

Despite certain similarities between the structure and methods of the co-operative society and the ordinary joint-stock company, there are several important, even fundamental, differences—

(i) No member of a retail co-operative society may, as a rule, hold more than £500 worth of shares.

(ii) The share capital carries a fixed rate of interest, and the profits in excess of this payment are distributed according to purchases made

(iii) The capital can be withdrawn on short notice.

(iv) Shares cannot be transferred.

(v) Voting is on an individual, not a share, basis

(vi) There is no limit to the number of members.

RETAIL ESTABLISHMENTS, 1950 AND 1957
Great Britain

	Number of establishments		Turnover		Number employed	
	1950	1957	1950	1957	1950	1957
			£ million	£ million	thousand	thousand
TOTAL RETAIL TRADE	579,813	573,443	5,100	7,790	2,408	2,569
1 Grocers and provision	140,559	148,988	1,232	2,040	510	550
2 Other food retailers	143,896	126,689	1,006	1,560	551	502
3 Confectioners, tobacconists, newsagents	74,613	77,429	503	706	254	285
4 Clothing and footwear	96,247	93,347	932	1,150	411	399
5 Household goods	65,062	64,787	571	884	251	285
6 Other non-food retailers	57,771	58,488	385	579	232	338
7 General stores (departmental, chain, etc)	1,665	3,715	471	872	199	310

Limitations of Co-operative Trading

Co-operative trading suffers from certain limitations, partly inherent in the system itself, partly arising from the method of organization

(i) **Limitations in Demand.** The co-operative society has hitherto made but a limited appeal to those with smallest means, who are able to pay only the lowest prices, and to whom the prospect of a deferred dividend on purchases makes little appeal Also, the co-operative movement does not as yet include such a large proportion of the professional and middle classes as the leaders would like. The reason may be personal aloofness, or the wish to purchase from a wider selection of less standardized goods, or simply indifference.

(ii) **Limitations in Supply.** Though the co-operative movement, in its productive departments, has branched out in an unexpected number of ways, by no means confined to the primary necessaries of life, there would appear to be certain types of industrial activity which

CO-OPERATIVE, INDEPENDENT AND MULTIPLE RETAILERS

	Turnover		Percentage Change in Turnover
	1950	1957	
	£ million	£ million	Per cent
TOTAL RETAIL TRADE	5,100	7,790	+ 53
Co-operative societies	572	905	+ 58
Independent traders	3,377	4,908	+ 45
Multiple retailers	1,151	1,977	+ 72
FOOD SHOPS	2,238	3,600	+ 61
Co-operative societies	432	707	+ 64
Independent traders	1,382	2,141	+ 55
Multiple retailers	424	751	+ 77
NON-FOOD SHOPS (including general shops)	2,862	4,190	+ 46
Co-operative societies	140	197	+ 41
Independent traders	1,995	2,766	+ 39
Multiple retailers	727	1,226	+ 69

it is not yet in a position to undertake. Where, for instance, there is a serious risk of loss, it is doubtful whether it is a proper function of a co-operative society, to which are entrusted the savings of its working-class members, to become greatly involved. The guarantee of a fixed interest on shareholders' capital, and the liability to have to repay capital at short notice, serve to restrain the local societies from becoming too venturesome. The wholesale societies, it is true, are in a better position to undertake risks, but even their powers in this respect are not so wide as those of the large capitalistic undertakings

Also, there are several long-established industries and services, which for one reason or another are likely to remain for a long time outside the scope of the co-operative movement Some began too early to enable the co-operators now to gain a footing. Others are concerned with primary manufacturing activities, such as heavy engineering, which it is hardly feasible under existing conditions for co-operative societies to undertake. Certain of the expensive luxury trades, too, are beyond the range of co-operative activity

(iii) **Limitations in Organization.** The scale of organization and quality of management in the local societies are frequently inadequate to meet the challenge of the more widely based multiples Schemes for amalgamation of small adjoining societies have had little success, while proposals to enable the wholesale societies to open retail shops in new areas, or for the establishment of series of "chain" stores as recommended by an authoritative committee in 1958, have had a mixed reception within the movement.

CHAPTER V

COMPETITION AND MONOPOLY

Section 1 *Perfect and Imperfect Competition*

Conditions of Competition

EXAMINATION of the economic structure may begin with the competitive system, even though, as will be shown below, free competition is by no means typical of modern industry, and the forms and degree of public intervention and control seem ever to be increasing. Competition manifests itself in a variety of ways, e g. rivalry between producers to obtain supplies and to find markets for their goods; between workers for employment; between investors for the most remunerative use of their capital; between alternative materials for a particular use (e g cotton and rayon); and so on.

Competition is said to be perfect—

(*a*) When buyers and sellers have complete information of market conditions;

(*b*) When perfect mobility exists in the disposition of labour, capital, and commodities—i e. when there are no restrictions on the movement of factors in search of the maximum return;

(*c*) When consumers as well as producers are free from restraint in the utilization of their resources;

(*d*) When no single body, whether an individual or a corporate group, has the power to determine the price or conditions of sale of a commodity or service.

Imperfect Competition

Perfect competition tends to be hindered by a number of circumstances, quite apart from public intervention and control. The chief reasons for the absence of free competition are—

(i) *Ignorance of producers and consumers.* Producers are frequently unaware of the nature and extent of their rivals' activities. Similarly, consumers are often ignorant of the needs of, and prices offered by, competing buyers.

(ii) *Custom and habit.* Custom may keep the market price above the level as determined by costs, though it can rarely, in a business world, keep it below.

(iii) *Immobility of labour.* Personal inertia and immobility, which were noted in Chapter II, frequently prevent the complete operation of economic forces.

(iv) *Long-period production.* In the long interval which commonly elapses between the initiation of production and the sale of the product it is not always possible to make an exact computation of changing conditions and to effect precise adjustments.

(v) *Large fixed capital.* Where a heavy capital expenditure is an essential preliminary to production, competition may be restricted

(vi) *Monopoly* Where there is a monopoly of producers, the price may be considerably above the cost of production; where there is a monopoly of buyers, the price may, for a time, be below the cost of production.

Industrial Combination

One of the important factors affecting competition is industrial combination or integration. Combination need not lessen the force of competition, and indeed in some cases intensifies it. In so far, however, as it is a stage in the formation of monopoly it is a means of establishing a control which may be fatal to competition.

Combination is said to be *horizontal* when the firms concerned have been engaged in a similar type of business They may unite for the purpose of securing—

(i) Lower prices from their suppliers,

(ii) Higher prices from their customers,

(iii) Economies resulting from a co-ordination of efforts, and elimination of overlapping activities and departments.

Combination is said to be *vertical* when the firms have been engaged at different stages in the production of an article The objective may be efficiency of production, or monopoly, or both Vertical combination alone may merely be a stage in large-scale economy, though it is not necessarily monopolistic, it may lead in that direction [1]

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[1] **Take-over bids** Mergers effected as a result of take-over bids have attracted much attention in recent times, but the operations in one form or another are by no means new Lateral combination of businesses engaged in similar activities, or vertical integrations between firms at different levels, have been a common practice from the early stages of industry With the development of the public company, however, and the spreading of share ownership the position of the bidder seeking control has been strengthened Normally the acquisition of 51 per cent of its voting shares is sufficient (It was largely to avert the possibility of outside interests gaining control that many companies chose to issue a large proportion of non-voting, usually designated "A," ordinary shares) Usually the bidder aims at more than a bare majority, and where he secures 90 per cent may evoke compulsory powers under the Companies Act to compel the sale of the remainder

The number and scale of take-over bids have been larger than the average in the last few years because of some special factors The policy of dividend limitation during the post-war period frequently resulted in the accumulation of large cash reserves, which, when the opportunity arose, were not always put to the most profitable use Also, during this period of rising prices, the buildings and other properties owned by a number of companies were not re-valued as they should have been in the formal accounts, and the understatement of these assets was naturally reflected in the market assessment of the shares Such a situation was bound to attract those who believed that they could employ the available reserves to better advantage, or make fuller and perhaps alternative use of the properties, and therefore offer the shareholders a figure well above the current market price In the process certain abuses came to light, not so much in the take-over schemes themselves as in the financial operations for their implementation In 1959 legislation was foreshadowed for tightening the conditions governing such operations, and for giving investors a larger measure of protection

These special circumstances should not be allowed to obscure the main forces ordinarily responsible for industrial combination, or to give an exaggerated significance to the take-over bid which is only one method among many of effecting a merger Subject to proper safeguards, what counts ultimately is the fuller utilization of the available resources Co-ordination of hitherto competing and perhaps overlapping units may reduce waste and lower costs The advantage of centralized buying may be accompanied by, or prepare the way for, improved marketing Integration between units at different levels may bring greater continuity of operation and enhance the economy of the whole enterprise

Section 2 Monopoly Organization

Conditions Favouring Monopoly

The nineteenth century was a period of acute competition. Under the new industrial régime manufacturers tended to take full advantage of the increasing returns accruing to large-scale enterprise. As the costs of production per unit diminished, the prices to the public were cut and undercut, until, in certain industries, only the firms producing in great quantities could sell their products at a profit.

As the size of these businesses increased, the rivalry between them was emphasized Firms were either crushed or absorbed by the new mammoth enterprises until comparatively few concerns were left in the field. Competition now became so intense that the alternative for many became still further combination or ruin. From this state of affairs emerged the Trust, which suppressed suicidal competition and controlled production and price.

Several factors have encouraged the formation of monopolies—

(i) The system of joint stock and free transferability of shares As already noted, a firm need only, as a rule, obtain the required majority of the shares of a rival concern to secure control

(ii) The necessity under modern conditions of large capital investment, often beyond the means of individuals and small firms.

(iii) The growth of large-scale operation and mass production in which the big firm has distinct advantages.

(iv) The localization of certain industries which tends to facilitate contact and arrangements between erstwhile rivals

(v) The spread of tariffs and subsidies which shield firms from foreign competition and encourage a common self-centred policy at home

Types of Monopoly

Monopolies are of several types, which depend to some extent on the conditions that bring them about—

(i) *Natural monopolies*, arising from the ownership of limited supplies of goods in their natural state; e.g. diamonds, radium ores.

(ii) *State-granted monopolies* These may take the form of patent rights, copyright, trade-marks, etc.; or they may be due to the public recognition of (iii)

(iii) *Monopolies that are, in certain industries, a necessary condition of full economic efficiency* It is wasteful to have competing enterprises in gas, electricity and water supply, tramways, postal services, etc. In such instances, the State or municipality insists on single direction, either by taking over the service itself or granting sole privilege to a limited number of concerns, reserving the right of final control.

(iv) *Monopolies that are themselves the result of efficiency.* Particular firms may achieve a monopoly position, not of set purpose, but as a result of their superior methods or organization

(v) *Monopolies that are the result of industrial combination brought about to eliminate competition, but not necessarily for purposes of efficiency* A restrictive arrangement may be devised with the object of keeping competitors out of the field, though their incursion might be for the good of the community. It is this form of monopoly which meets with the severest criticism

(vi) *Temporary monopolies*, such as the "cornering" of supplies. This type, too, is generally condemned.

Forms of Monopoly Structure

The principal stages in monopoly structure are set out below. A particular combine may partake of more than one type of organization, or adopt more than one form of practice.

(i) Agreement to fix prices, which may or may not be accompanied by a—

(ii) Division of the market. It is a common practice for combinations to allocate fixed selling areas to the component firms.

(iii) The Pool. Under this arrangement the profits are pooled and divided among the firms in proportion to the respective volumes of business.

(iv) The Cartel, and

(v) The Trust. These two important forms of monopolistic structure, covering also to some extent (vi) and (vii), are dealt with more fully below

(vi) The Merger. This is but an advanced form of trust. The principal company may buy and cancel stock of other companies, which thereby cease to exist.

(vii) The Holding Corporation This is a nominally independent company, which holds a major proportion of shares in the other companies, thus obtaining virtual control

The above forms of monopoly organization do not, of course, include those undertakings conducted or supervised by the State or other public authority. The structure of such undertakings varies considerably. The postal and railway services, for example, are nationally owned concerns with complete monopoly powers Local authorities commonly have sole powers in operating transport and other services. In recent years there have been important developments in public utility companies which are financed on a private basis and earn dividends for their shareholders, but which are subject to the overriding control of the State both in the general policy and in the fixing of charges Still another important innovation is to be found in the State marketing boards which, while leaving the physical processes of production more or less in private hands, exercise control in varying degree over the total volume of output, the prices to be charged, and the disposition of the products

Another form of monopoly is to be found in various restrictive practices on the part of trade associations or individual firms One of the most prevalent is that of retail price maintenance, whereby shopkeepers, under penalty of having supplies withdrawn, are forbidden to charge lower prices than those prescribed by the manufacturers acting either in concert or alone.

Cartels and Trusts

Some monopoly organizations take the form of a selling agency, commonly described as a Cartel. The associated firms, which retain their identity and independence up to a point, establish a central sales bureau through which all their output must be distributed. The cartel fixes the selling price and the quotas of the participating firms in such a way as to obtain the maximum total profit. Firms that exceed their quota are liable to be fined; those that produce less may receive some compensation. The cartel is thus a federation rather than a physical amalgamation of firms, but the organization may become so closely-knit as to resemble an actual integration.

The Trust (which derives its name from "trustees," in whom originally the control of combined firms was vested) takes the form of an amalgamation rather than an association of firms, and has thus a closer and more unified structure. The cartel ordinarily links up firms in a horizontal direction. The trust often, though not necessarily, entails a vertical integration as well.

The cartel enjoys a certain advantage over the trust in that the members have a greater freedom of action and opportunity for enterprise. The trust, on the other hand, benefits from a more centralized and co-ordinated system of organization, resulting in a more effective control.

Rationalization under Monopoly

Rationalization is ordinarily taken to comprise those measures for securing an economic deployment of resources both within the factory and in the organization as a whole Although these measures by no means depend on monopoly for their execution, a combine is in some ways in a stronger position to put them into effect Among the benefits of rationalization, apart from the already noted advantages of large scale operation, are—

(i) *Concentration of production in the best equipped factories.* Though rationalization often entails the closing-down of redundant establishments, it is usually the less efficient units that are so affected.

(ii) *Regular instead of intermittent production.* If there have been too many factories prior to the association, regular working of them all results in over-production It is more economical to have a comparatively small number of works producing all the year round than a large number working intermittently. This also leads to regular and ready supply.

(iii) *Saving in distribution costs* A single sales organization may be substituted for a number of hitherto overlapping departments

(iv) *Economy of freights* It is not unusual for a manufacturer to send goods to a market close to a factory producing identical goods, while the latter supplies customers within easy reach of the former. Such cross-freights are very wasteful, and are more easily eliminated under single control, each factory being required to supply the nearest market.

(v) *Patent rights, special brands, and trade-marks* Exclusive benefits hitherto enjoyed by individual firms may now be enjoyed by other members of a group.

Objections to Monopolies

Such benefits, however, may be largely offset if the organization comes under monopoly control—

(i) *Prices usually raised and output restricted.* When competition is keen, prices are apt to be low, but they tend to be increased as soon as an amalgamation or some form of association is reached. There is the danger, too, that the output may be unduly restricted. Thus, stocks may be deliberately destroyed, as was the practice with coffee in Brazil. Or some of the industrial plants or raw material resources may be left idle or worked below capacity, the method that was adopted at one time in the rubber industry.

The theory of monopoly prices and the methods of price discrimination are considered in Ch. VII, Sect. 2. For the present it may be stated that a monopolist will not necessarily charge a high price if a reduction in demand is liable to result Much depends upon the nature of the article, the elasticity of the demand, and the possibility of a substitute. It may yield a higher net profit to sell a large quantity at a low price than to sell less at a high price.

(ii) *Unfair methods of competition.* It is a common criticism of certain trusts that they have frequently eliminated competition by selling for a time under cost of production until the rival has been compelled to give way; by charging different prices for the same products according to the capacity of the degree of competition in particular areas; by deferring discounts that are contingent upon the placing of further orders; by allowing secret rebates to influential customers; and by other questionable methods.

(iii) *Unemployment* caused through the discharge of factory hands, salesmen, travellers, etc. This need not be a disadvantage in the long run, if there have been too many firms producing, and if in fact the industry has been suffering from under-employment in the form of short time.

(iv) *Speculation and over-capitalization* made possible on the formation of trusts. In floating the new company, stock is often issued to an amount that exaggerates the capitalized value of the additional profit-earning capacity.

(v) *Slackening of efficiency.* The elimination of competition between rival firms is liable to weaken enterprise and incentive, particularly if the size of the organization grows to an unwieldy extent. Also a combination may include a number of inefficient units that survive only because of a vested interest

Limits to Monopoly

The power of the monopolist varies with different industries and organizations, and may be limited by a number of factors, some operating from within, others from without.

(i) The monopolist may predetermine price or supply, but in doing so must usually take demand variations into account.

(ii) To charge unduly high prices may invite competition, either in the same field or in that of substitute commodities.

(iii) An association of firms that is established mainly for purposes of price fixing may prove to be unstable in time of difficulty.

(iv) Where a monopoly takes undue advantage of its power, there is the possibility that the State will intervene and impose some restraint. It is true that many States nowadays favour certain forms of monopoly organization, but in such cases there is usually some degree of public control for the protection of the consumer.

The Control of Monopoly

Measures for restoring competition. Various attempts have been made in different countries to prevent or minimize the abuses of monopoly In the United States various anti-trust laws have been passed, but with limited success. Provision was made for splitting an amalgamation into its component parts, but with the nominal breaking-up there emerged the "holding corporation," a super-company which held all, or a majority of, the shares of the subsidiary companies, thus exercising a control as strong as that of the original "trustees." Attempts to prevent the practice of discriminating prices were countered by special "fighting brands" which had only one price, but whose sale was restricted to areas where a rival was in the field

Measures for protecting the consumer. Recognizing the difficulty, even futility, of attempts to break up a monopoly into competitive units, governments have more recently concentrated upon measures intended to protect the consumer against exploitation. One policy is to impose a maximum scale of charges. Though certain industries lend themselves to such regulation, because of their standardized and easily graded products or services, others are not so suitable, particularly those which cater for individual needs and in varying qualities.

A second method is to place a maximum on the profits rather than on the price. Such a practice has for long been employed in regard to gas and water supply companies and other public utility undertakings. But most monopolies are not so readily controlled, and would present considerable difficulty even if the desirability of limiting their profits were accepted in principle.

Legislation against restrictive practices Under the Monopolies Act of 1948 the Government appointed the Monopolies Commission, and empowered the Board of Trade to employ this body to investigate any industry in which at least a third of the goods was supplied by one or two firms In 1949 the first six industries for investigation were named (electric lamps, matches, etc), and subsequently other trades were brought under review. Although, as a result of these investigations, a number of restrictive conditions were relaxed, progress was slow.

In 1956 the Restrictive Trade Practices Act came into force Registration of schemes of price fixing and the like became compulsory, and provision was made for tribunals to consider allegations of restrictive and discriminatory practices One example of the operation of this Act was the ruling in 1958 that the prohibition by drug manufacturers on the sale of certain medicaments by retailers other than pharmacists was unduly restrictive. Another notable decision was taken in 1959 when an agreement between the members of the Yarn Spinners' Association fixing minimum prices for cotton yarns was held to be contrary to the public interest and accordingly void Similar rulings were announced in the same year against the Federation of Carpet Manufacturers and the Federation of Wholesale and Multiple Bakers.

The indirect effects of the Act were in some ways more significant than the decisions in the contested hearings In the majority of cases a warning letter stating that an agreement was to be referred to the Court proved sufficient to bring about its modification or abandonment. In September, 1959, it was announced that 600 agreements on the register, or more than one-quarter of the total, had been voluntarily terminated.

PART II

VALUE

CHAPTER VI

THE THEORY OF VALUE

Section I

The Labour and Cost of Production Theories

The Nature of Exchange and Value

In the foregoing analysis it was pointed out that production is nothing more than the creation of utilities Any man who adds a utility is a producer. Shopkeepers and carriers may add nothing tangible to the goods they help to distribute, but their services are indispensable. The utility they add is not one of form, but one of time or place.

It used to be contended that if one man benefited by exchange, another man must necessarily lose. This notion, however, is misleading It is now held that if A exchanges, say, his watch for B's cycle, A considers the cycle to be worth to him *at least* as much as the watch, while B regards the watch *at least* as highly as the cycle Both parties may gain by the transaction, proving the adage that "exchange is no robbery." Similarly, in the employment of money, the utility of the thing bought is not less than that of the money given. In Jevons's words, exchange is generally accepted as being the "barter of the comparatively superfluous for the comparatively necessary."

The most fundamental problem in exchange, and, indeed, in the whole of economic science, is the determination of the principles governing the exchange-power, or value, of a commodity or service.

In ordinary speech the word "value" is employed in several senses. We speak of the value of food, the value of a suit of clothes, the value of fresh air, the value of literature, and so on. In early economic writings the distinction was commonly drawn between "value in use" and "value in exchange," but modern economists prefer to employ the terms "utility" and "value." By the former they mean the capacity to satisfy a want; by the latter the power of exchange that one commodity has for another.

Price indicates the value in exchange as measured in terms of money The theory of value has a wider application than the theory of money prices, which will be considered at a later stage.

Value as Regulator

In a free society value serves as regulator of economic activity. It serves as a guide to *producers*, who tend to adjust the character and scale of their output according to the market valuation. A high value may be regarded as a sign of scarcity and thus stimulate producers to increase their supply. A low value may be interpreted to denote a large supply, and producers may curtail their output in consequence.

Similarly, *consumers* regulate their purchases according to the respective values, and thereby, indirectly, to conditions of supply. A low value tends to encourage consumption; a high value to limit it. Thus, under conditions of plenty a low value enables stocks to be quickly consumed; under conditions of scarcity a high value serves to conserve the stocks and spread their consumption over a longer period.

Also, in *distribution* value serves, up to a point, to regulate the shares paid in the form of wages, profits, interest and rent, and the individual amounts paid within each group The factors of production compete in a sense for employment and, if the competition were perfect, the rewards would correspond to their respective contributions to the total The relationship of value, however, to distribution is not so evident as it is to production and consumption, particularly as in the apportionment of the social income authoritarian and other forces, such as subsidies, social services, minimum wage legislation, etc , play a very important part

Labour and Cost Theories of Value

It is helpful, before proceeding to the modern theory of value, to review in outline the earlier attempts at explanation, for realization of their failings assist one in comprehending and appreciating the later doctrine

The Labour Theory was expounded at different times and in different forms by Adam Smith, Ricardo, Rodbertus, and others; but it was left to Karl Marx to develop it most fully, and the theory is usually associated with his name.

Briefly, it states that the value of anything depends on the amount of labour embodied in it. Labour is considered to be the source and measure of all values The exponents of this theory recognize the necessity of capital goods, but prefer to consider them as the products of past effort, regarding them, in effect, as "crystallized labour."

Marx and his followers used this doctrine as a weapon against the capitalist organization of society. Labour, they maintained, creates all value, but is paid only a bare subsistence wage. The difference between the real product of labour and the wages paid is the "surplus value" which goes in the form of interest, profits, and rent to the capitalist class.

While Marx did not overlook (as is sometimes asserted) the condition of utility, he could not accept it, owing to its variability, as a factor determining value. Adam Smith had pointed out nearly a century before that things with the greatest "use-value" often had a low exchange-value (e g. water), while things with an apparently low "use-value" had a high exchange-value (e g. diamonds). This "paradox of value" only confirmed Marx in disregarding utility as a standard in the fixing of value.

The Cost of Production Theory, resting on a broader basis, states that the value of a commodity is governed by the cost of the various factors employed in its production Like the labour theory, it argues from the side of supply; different from that theory it takes into account the agents of production besides labour. Under free competition the theory has a certain plausibility, since high profits due to a large surplus of price over cost will attract competitors, who will add to the supply and reduce the price; while low profits or a loss will drive producers out of the market, causing a shortage in supply and a consequent rise in price. Eventually, it is maintained, the price must equal the cost of production.

These early cost theories of value are subject to some common criticisms They both approach the problem chiefly from the side of supply, giving insufficient consideration to utility and conditions of demand. They do not satisfactorily account for "scarcity value," or for changes in value after production is completed, nor do they allow sufficiently for possible misdirection of labour and other resources.

Early Utility Theories

Following the economists who attempted to find the explanation of value in supply came those who sought for it in utility, the basis of demand. Gossen, a German writer, put forward the notion that the value of a commodity bears a direct relationship to the satisfaction or enjoyment it yields. Further, "with increase in quantity, the value of each added unit must undergo a continuous decrease until it sinks to nil" Some years later W. S. Jevons[1] formulated the theory in more precise terms. He concluded that "the ratio of exchange of any two commodities will be the reciprocal of the ratio of the final degree of utility of the quantities of commodity available after the exchange is completed. . . . The final degree of utility is that function upon which the whole Theory of Economy will be found to turn."

It can readily be proved, however, that a theory based entirely on utility is no less one-sided and misleading than a theory based on labour or cost alone. Obviously, no explanation of value can be complete that does not take conditions of supply into account. The later form of the theory, as will be explained below, pays equal attention to both sets of conditions. Though the doctrines of the above writers are found to be inadequate, their method of treatment, especially involving the conception of "marginal" increments, helped to provide a foundation for modern theory.

Section 2. The Marginal Theory of Value

In the following analysis value will be studied in turn from the sides of demand and supply. It will be shown that the marginal utility is the governing factor in demand, that the marginal cost of production is the governing factor in supply, and that value tends to be determined at their point of coincidence.

Conditions of Demand: The Law of Diminishing Utility or Satiable Wants

It is necessary at the outset to consider the Law of Diminishing Utility or Satiable Wants which states that the additional satisfaction that a person receives from an increase in the supply of anything that he possesses, diminishes with every unit that is added to the stock. In other words, the total utility of a thing increases at a slower rate than an increase in the stock.

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[1] The Austrian school of economists can claim equal credit for the development of the utility theory See Appendix

A person who is hungry obtains considerable satisfaction from his first slice of bread. Though his hunger is not satisfied, the edge has been taken off, and he will probably derive less utility from the second than from the first.[1] In the same way, a person who is sight-seeing finds that the pleasure derived from view after view gradually declines, even though the sights are of equal interest in themselves. This tendency to diminishing satisfaction is apparent in all forms of consumption, and rests upon man's physical and mental nature It is conceivable that if a commodity is consumed beyond a certain point (as in over-eating) the utility of additional amounts may fall to zero, or even below, in which event, with satisfaction giving place to discomfort, *disutility* may be experienced.

It is essential to realize that the amount and quality of the successive units do not vary. Each slice of bread in the above example is identical, yet each gives less satisfaction than the one previously consumed. The fact that these units are interchangeable as regards quantity and quality is of considerable importance in the formulation of the marginal doctrine.

Diminishing Utility of Money

Diminishing utility occurs not only in the consumption of goods, but also in the use of money with which to buy those goods With the first part of his income a man normally acquires the essentials of life and devotes the remainder to the purchase of goods in a diminishing order of necessity. A man with twice the income of another does not necessarily derive twice the satisfaction, so far as this can be measured, while the utility from the last pound of a very wealthy person's income may be fractional compared with that from a pound of a poor man's income

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[1] It might appear that increasing utility exists in certain cases Thus, if 3 yd of cloth are necessary for a garment, a cut length of 2 yd would have less than two-thirds the utility of 3 yd An extra yard would thus afford increasing utility Yet, it may properly be contended, diminishing utility really obtains, since 3 yd, and not 1 yd, constitute the proper unit for comparison, and an additional length of 3 yd would in general give a smaller satisfaction than the first length

Diminishing Utility and Public Policy

The law of diminishing utility has a certain application to public policy. Reformers who aim at a more equal distribution of the social income deduce from this principle that a redistribution is by itself capable of increasing the total satisfaction in a country (provided, of course, that the redistribution is carried out in such a way that it does not impair the will and power to produce, and thus reduce the total income of the community). If a hundred pounds deducted from a rich man's income would mean only the sacrifice of comparatively little utility, while the addition of that amount to a poorer man's income would increase the latter's satisfaction by more than the rich man had lost, methods should be devised, they say, to redistribute the national income on a more equitable basis. In short, it is claimed to be possible to increase the aggregate satisfaction without *necessarily* increasing the total production

Recognition of the principle of diminishing utility is, in effect, incorporated in the existing system of graduated taxation. Suppose A and B to have incomes of £2,000 and £500 respectively. If the income tax were *proportionate,* say 10 per cent, A would pay four times as much as B, viz. £200 compared with £50. But, as a general rule, the loss of £200 to A would mean relatively less sacrifice than the loss of £50 to B In the British income tax system, as is shown in a later chapter, the principle of *progression* has been carried to an advanced stage, though it must be admitted that the high yield from graduated taxation has in general been the leading motive.

Marginal Utility

It has been seen that the utility of additional units of a commodity diminishes with extra supplies This does not imply, however, that a person will continue his purchases until the utility drops to zero; on the contrary, he will, consciously or unconsciously, be comparing with this utility the possible satisfaction to be derived from the consumption of other commodities. When a man is hungry, the utility obtained from 2d worth of bread exceeds that from 2d worth of cake A second and a third 2d. worth of bread may, despite diminishing utility, still afford greater utility than can be obtained from the same expenditure on cake But after a certain point he finds that 2d spent on cake yields more utility than that from a further 2d. worth of bread. The utility derived from that unit which the consumer is just persuaded to acquire is called its **marginal utility.**

The marginal utility need not be the smallest utility to be derived. It is simply the utility of that amount which, in the opinion of the consumer, is just worth purchasing at a given price. The position of the margin is not permanently fixed, even for the same person; it may move up or down according to different circumstances. Thus, a fall in the price of a commodity may induce a man to put it to some inferior use not considered worth the expense before. Or an increase in a man's income may have the same effect. In both cases the marginal utility of the article will tend to fall. Conversely, a rise in the price or a fall in the income will tend to cause the margin to rise.

In perfectly competitive conditions there can be only one price for a commodity at a time. To differentiate in prices according to the variation in utility would be practically impossible. At any given price there are some people who obtain the commodity for less than they are really prepared to pay. On the other hand, there are some who do not purchase it, because they estimate the utility of the commodity to be less than that of something else which they can buy at the same price But there is the intermediate class of person who considers that, while he would not pay more, he is just prepared to purchase the commodity at the price charged. He is the **marginal purchaser.**

The Law of Substitution in Consumption

It follows that **a consumer tends to regulate his purchases of different articles in such a way that the marginal satisfactions derived from them are equal.** In other words, he derives most satisfaction from his expenditure when he obtains equi-marginal utilities from all the commodities consumed.

This may be illustrated by a simple example Suppose that a person is buying tobacco and chocolate for his own consumption, and has 2s. to spend. The table on p. 77 illustrates the degrees of utility to be derived from successive fourpennyworths of tobacco and chocolate. On the basis of these hypothetical figures, it is clear that if he wishes to get the maximum satisfaction for his outlay, and assuming it is possible to make precise calculation, he will spend 1s 4d. on tobacco and 8d. on chocolate, for at this point he derives 47 units of satisfaction, the highest in the scale. Another 4d. on chocolate would mean the loss of 1 unit; another 4d. on tobacco would mean the loss of 3 units.

The tendency to equi-marginal utilities is differently expressed and is better known as **the law of substitution.** A consumer tends to substitute one commodity or unit of it for another to the point where the respective marginal utilities are equal. At this point the satisfaction is at the optimum. The principle of substitution, which will be shown below to operate also in production, is of first importance in all branches of economic activity.

MARGINAL AND TOTAL UTILITY

Pence	Marginal Utility of Tobacco	Total Utility of Tobacco	Marginal Utility of Chocolate	Total Utility of Chocolate
4	10	10	8	8
8	9	19	7	15
12	7	26	5	20
16	6	32	4	24
20	4	36	3	27
24	3	39	2	29

2s	spent on	tobacco	yields	39	units of	satisfaction	Total, 39
20d	„	tobacco	„	36	„	„	
4d	„	chocolate	„	8	„	„	Total, 44
16d	„	tobacco	„	32	,	„	
8d	„	chocolate	„	15	„	„	Total, 47 (optimum)
12d	„	tobacco	„	26	„	„	
12d	„	chocolate	„	20	„	„	Total, 46
8d	„	tobacco	„	19	„	„	
16d	„	chocolate	„	24	„	„	Total, 43
4d	„	tobacco	„	10	„	„	
20d	„	chocolate	„	27	„	„	Total, 37
2s	„	chocolate	„	29	„	,	Total, 29

Marginal Utility and Price

The relationship between marginal utility and price may be carried a stage further. Suppose a woman to be buying butter, which may be used for more than one purpose in the household, and for which there are, of course, possible substitutes. It should be realized that the woman is only one of thousands of purchasers, for whom, in a perfect market, there can be only one price at a time. Her demand schedule at a certain moment may be imagined as follows—

5s 6d	for the	first	pound
5s od	„	second	„
4s 6d	„	third	„
4s od	„	fourth	„
3s 6d	„	fifth	„

How many pounds of butter will she buy, and at what price? It is evident that if the price were 3s. 6d. per lb., she would buy 5 lb, if the price were 4s she would buy 4 lb, if 4s 6d, 3 lb, and so on.

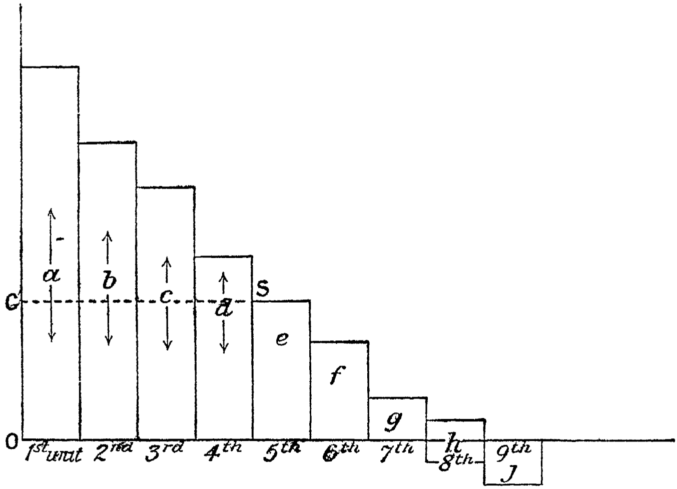

DIAGRAM ILLUSTRATING DIMINISHING UTILITY, TOTAL AND MARGINAL UTILITY, AND CONSUMER'S SURPLUS

In this diagram rectangle a represents the utility derived from the first unit of anything, b the utility from the second, and so on

The utility is seen to diminish, until the eighth unit h is on the border between utility and disutility A ninth unit j would yield complete disutility

Suppose the fifth unit is the one which the consumer just finds it worth while to purchase at the price, e will represent the marginal utility The total utility will be $a + b + c + d + e$ The consumer's surplus will be the inclusive area above line CS and may be represented as total utility *minus* $5 \times e$

Assuming that the actual price is 4s. 0d. per lb., the marginal pound of butter will be the fourth. It is just worth buying 4 lb. of butter at that price; to buy 5 lb. would mean paying another 4s for an extra 3s 6d worth of utility. Since the pounds of butter are identical and interchangeable, the marginal utility of the fourth pound may be attributed to any other pound, and the price of the marginal pound of butter will be the price per pound of all the butter purchased. Otherwise one would be paying different prices for the same thing according to the varying utilities derived from it. It follows that **the price measures the marginal utility of the article purchased.**

In seeking to employ his money to the best advantage the purchaser tends to evaluate and compare the degrees of utility of the commodities competing for his custom. Assuming full knowledge on his part, it may be generalized that the prices paid tend to equal the respective marginal **utilities as measured in terms of money and relatively to the marginal utility of money.**

The woman who bought 4 lb. of butter would derive 5s. 6d worth of utility from the first lb., 5s from the second, 4s 6d from the third, and 4s from the fourth, a total utility of 19s Presumably she would have been prepared to pay this sum rather than go without the 4 lb But, as shown above, she would pay only 16s for the 4 lb. (i.e. four times the utility of the marginal pound, measured in money). The difference between the price that one would be willing to pay, and that which is actually charged, is termed a "consumer's surplus," here equivalent in terms of money to 3s

Since the woman would derive 19s worth of utility from an outlay of 16s, it may be asked why was she not charged (say) 4s 8d per lb, i e. 18s 8d for 4 lb, seeing that she would still be getting 19s 0d. worth of satisfaction for a smaller outlay? The answer has already been implied, but may be given more explicitly—

(i) If the price were 4s. 8d, the woman in question would not buy the third and fourth pounds, which represent only 4s. 6d. and 4s worth of utility respectively

(ii) She is only one of thousands of purchasers, each of whom has varying preferences Some would pay more, some less, than the woman in the example. A different price for every one would mean chaos.

It has already been shown that consumers tend to substitute alternative means of satisfaction for each other until the point of maximum satisfaction is reached. All exchange is based on this principle. One commodity is not exchanged for another unless the marginal utility to the seller is less than that to the buyer. The ratio of marginal utilities as between the parties to an exchange has been described as the marginal rate of substitution. Further, since the diminishing utility of successive units of one commodity leads to the substitution for units of another commodity, some economists prefer to describe diminishing utility as the increasing marginal rate of substitution.

Conditions of Supply: Cost of Production

The central factor in demand, it has been shown, is utility. The central factor in supply is cost of production. As implied in the account of the earlier cost theories, the term "cost of production" is not free from ambiguity. A distinction is sometimes drawn, for instance, between the *real cost* and the *expenses* of production. The former conception denotes the sum of the efforts and sacrifices incurred, whereas the latter is an expression of these (so far as it is practicable) in monetary terms Theoretically, cost of production might be said to resolve itself into terms of alternative uses. Since the supply of labour and materials is limited, some possible uses cannot be fulfilled, but, it can be argued, note ought to be taken of them in estimating the real cost. In reality, however, it is impracticable to measure and compare costs in this way, especially as they involve personal preferences and sacrifices.

A distinction of more practical application is in the division of the costs of production into *prime costs* and *supplementary costs* By prime costs is meant the specific expenditure on the product on account of material, labour, etc., but excluding the general establishment costs of the factory. The prime costs stop when a factory stops. Supplementary costs, on the other hand, are regular establishment charges, like rental, taxes, interest, etc., which continue to be incurred whether the factory is running or not.

The importance of the distinction is seen in slack times. A manufacturer with large supplementary costs is not so ready to stop producing as one with low supplementary charges, and may be willing for a while to produce for the price of labour and material only. It is usually less disadvantageous to adopt such a course than to close down entirely for a period, for on the return of good times the plant is in working condition for coping with fresh orders while the difficulty of having to secure, and possibly train, new labour supplies is obviated.

Similar considerations may apply in the disposal of one's products abroad, especially if the exporter has to face severe competition. The goods may sell at home at a price that covers prime and supplementary costs, with perhaps something over. But, in order to gain full economies of large-scale production, it may be necessary to turn out a greater volume of goods that can be disposed of at home without "spoiling" the market. In these cases lower prices may be charged abroad, leaving but a small margin over prime costs. Such practices are akin to dumping, to which reference is made later (p 244)

The Marginal Firm and Marginal Cost

Just as utility varies from consumer to consumer, so cost varies from producer to producer. At a single time there may be several firms producing an identical commodity at varying costs, according to the different standards of organization and efficiency. Which firm's cost is the determining factor? The answer is that of the marginal firm, i.e the firm which just manages to pay its way. (There may, of course, be more than one such firm at the margin) Its costs are higher than those of the supra-marginal firms producing at the same time, but, as the demand is sufficient to absorb the total output of all the existing firms at a price equivalent to the costs of the marginal firm (including the cost of selling and the minimum profit without which one would not normally carry on), these costs will tend to equal the supply price of all the firms. Though it is possible for the supra-marginal firms to sell for less (since their costs are lower than those of the marginal firm), they will not ordinarily do so because they are able to sell all their output at the higher price. A firm will not as a rule sell at a price below the cost of production, but will charge as much above as it can get.

In a similar fashion it can be shown that an individual firm tends to produce up to that point at which the selling price of the article just compensates for the cost of producing it. The firm may experience a diminishing return, i e an increasing unit cost. Even if the physical volume of output is still showing a tendency to expand, the greater supplies placed on the market may cause the price to fall. Thus, not only is there a firm, or group of firms, that may be described as marginal, but there is also a stage of marginal cost that sets an economical limit to the extent of production of any firm.

It follows from what has been said that there is a "producer's surplus" comparable to the "consumer's surplus," described above. In a group of firms turning out a given article, there are some producers who are making a profit over and above that with which they would be satisfied under less favourable conditions. Similarly, some of them are making an additional profit on that part of their output which is produced at less than the marginal cost. More will be said on such surpluses in Chapter XI.

The Law of Substitution in Production

It was shown above that a consumer tends to lay out his expenditure in such a way that the marginal utilities of all the things purchased are equal. In the same way, **a producer tends to employ the factors of production in such proportions that the marginal returns from each are equal.** If a sum of money is about to be added to a business, and can be spent in the form of new plant or more labour, or both, the entrepreneur will try to apportion the expenditure in such a way as to get the maximum return, and this will be attained when the marginal returns are equal.

Firms above the margin may be tempted to increase their output, but some at least be dissuaded from doing so because they are already near the limit of economic production. **A firm tends to produce up to the point at which the marginal costs equal price.** Production beyond that point would mean adding more to the costs than to the receipts.

At any given time, therefore, a number of firms are producing similar goods at varying costs, but are all selling them at one price. This price tends to equal the costs of the marginal firm, or, simply, the marginal costs of production.

Marginal costs, it should be noted, are not permanently fixed any more than is the marginal utility to the consumer. The position of the margin in either case is determined by, as much as it determines, the level of the price.

Importance of the Time Element

Certain changes that occur over a long period of time necessitate a qualification of the general theory of value as stated. In a short period the technical equipment for production is usually limited, and producers can increase their output only by working their plant more intensively. Obviously there is a limit to the additional output that can thus be obtained At any particular time the price tends to equal the highest cost of production. But over a long period conditions may undergo a considerable change. Producers may find it possible, if required, to extend their plant. Firms that were above the margin may increase their output in order to derive greater profits, and may desire, following the saving in unit production costs, to reduce the selling price It is still true that, under the altered conditions, price approximates to the highest cost operating *at the time*, but the level of the margin is lower under the new than under the former conditions. Thus, although the price tends to approximate to the highest cost at any specified time, it tends to equal the lowest cost over a long period.

Further, the power of demand in determining value tends to be more influential in the short than in the long period. In general, the supplies in a short period are relatively fixed, though they are alterable over a long period. The demand, however, may be variable, irrespective of the length of the period. Hence, in a short period the buyers have a certain bargaining advantage over the sellers. Eventually the producers are able, as a rule, to adjust their supplies to the requirements of the market, and thereby to improve their bargaining position.

It is possible, therefore, to generalize that the respective powers of demand and supply over price vary to some extent with the length of the period. *In a short period demand tends to play a bigger part than supply in determining value. In a long period supply tends to have a greater influence.*

Provisional Conclusions on the Marginal Theory

The labour and the cost of production theories were seen to be deficient mainly because they attempted to explain value from the side of supply alone. A theory which attempted to explain value from the demand side only would have to contend with at least as many difficulties. In the modern theory both supply and demand are given due weight.

It has been shown that the governing factor on the side of demand is marginal utility, and that the main influence on the side of supply is marginal cost

Demand and supply tend to balance at a point at which the marginal utility is equal to the marginal cost of production, both as measured in terms of money. This point indicates the value The shorter the period, the greater is the influence of conditions of demand; the longer the period, the greater is the influence of conditions of supply.

The marginal theory satisfactorily overcomes many of the difficulties that beset the earlier attempts to explain value, which were shown to attach too little importance to conditions of demand. Thus, the labour and the cost of production theories failed to account satisfactorily for the low value following a misdirection of resources. The explanation lies largely in the low utility of the marginal units. The earlier theories did not account for the high value attaching to commodities that were scarce, or the changes in value subsequent to the time of production. Here, too, the reason is to be found mainly in the level of marginal utility The marginal theory also disposes of the so-called "paradox of value," proving that there is really no paradox at all. The total utility of a commodity may be very high, but, if the supply is so abundant as to cause the utility of the marginal unit to be very low, the value of the whole is determined accordingly.

Limitations of the Marginal Theory

Though the marginal theory of value has proved more adequate than the preceding attempts at explanation, it has been subjected to criticism on the score both of incompleteness and of the method itself.

(i) It is submitted that to relate utility and cost, and to express them in common, usually monetary, terms, over-simplifies what is a very complex interaction between subjective and objective forces.

(ii) It is questioned whether total utility and total cost, can be broken down into the very small units postulated by the theory, and whether the marginal fractions can be measured and compared.

(iii) It is doubted whether consumers and producers can and do in fact vary the quantities and qualities and substitute one unit or grade for another until equilibrium is reached.

(iv) It is objected that the theory is far from reality; that human motives and behaviour do not respond always in the manner stated.

(v) It is pointed out that a person's behaviour in relation to exchange is not permanent or stable, but that it is constantly varying.

(vi) It is contended that a person's scale of preferences is determined by his income and that his estimates of value rise or fall, but not necessarily in the same degree, as his income changes.

The general answer to criticisms such as these is that the marginal theory affords a method of approach rather than a complete statement of governing conditions. In the words of Marshall, who did more than anybody else to develop and apply the theory, "*one has to go to the margin to study the action of those forces which govern the value of the whole.*" To state that the operation and interaction of forces can be most clearly observed at this point is not to imply that the marginal factors are themselves the sole determinants of value. Regarded in this light the marginal theory commands wide, if not universal, acceptance

CHAPTER VII

SUPPLY AND DEMAND

Section I. *Competitive Price*

Evolution of the Market

THE word "market" used to refer to a place or building where sellers and buyers congregated for the purpose of sale and purchase. The meaning, in principle, has remained the same, but has been extended to cover a set of conditions not necessarily confined to a particular place. Thus the evolution of the market may be viewed territorially or functionally.

(i) **Territorial evolution** denotes the growth of the market in the purely geographical sense. Beginning on a small scale, confined to buyers and sellers in a restricted area (perhaps a village), the market grew in extent, according to the goods dealt in, until it covered possibly a whole region or country. Under favourable conditions it extended beyond national boundaries and became world-wide.

Instances of the market in these various stages are common. The sale and purchase of perishable farm and garden produce favour local dealings, though the development of transport and means of preservation has in modern times enlarged the area of the market. The marketing of heavy goods that have little value in relation to bulk is restricted in area on account of transport costs. At the other extreme are such commodities as gold and precious stones, which, on account of the universal demand and the very low transport costs in relation to value, enjoy a world market.

(ii) **Functional evolution** denotes the development of the market according to the method of dealing. It is naturally related to, but it is not circumscribed by, territorial conditions. Thus the general market, in which a wide variety was offered for sale, came to be divided and specialized, both in place and time, according to the changing conditions of demand and supply.

In the functional evolution of the market, an important stage was marked by dealings according to *sample.* This method obviated the necessity of bringing the whole of one's stock to market, and resulted in considerable economies in transport and storage The area of the market was extended and competition became more effective.

Another stage was reached when goods could be marketed by *grade.* Where the articles offered for sale could be exactly described and graded, it was not necessary to bring even samples to the market, and the sphere of the market and of competition was further extended

Conditions of a Perfect Market. From what has been said it follows that a perfect market requires the following conditions to be fulfilled—

(i) Wide and regular demand ;

(ii) Easy and speedy means of communication between buyers and sellers throughout the market;

(iii) Free competition among sellers and among buyers;

(iv) Portability of goods at low cost relative to bulk,

(v) Capacity of goods to be uniformly described and graded.

These conditions are by no means universal, but for purposes of exposition many conflicting factors will be ignored for the present. Thus it will be assumed—

(*a*) That the supply of commodities is fixed and known, and that the stocks held by the different dealers are also known;

(*b*) That the wants of the consumers remain unchanged during the market operation, and that the scale of preferences is not influenced by anything else than price variations;

(*c*) That the market is isolated in time, and that there is no question of re-exchange at a later date.

It will also be assumed that the conditions of perfect competition, enumerated at the beginning of Chapter V, are fully operative.

Normal Price and Market Price

The **Normal Price** is the price that obtains through a long period, the pivot, as it were, about which the varying prices oscillate. Not necessarily the average of actual prices, it is the price which would result from the economic forces in a given period, if these forces were permitted to work without hindrance.

The **Market Price**, on the other hand, is the short-period price at which the amount offered for sale is equal to the amount demanded. Price variations are a common feature on the markets and, where the article is seasonal or perishable, the fluctuations are liable to be very pronounced

If the market price is higher than the normal price, production tends to be increased until the price falls. If, on the contrary, the market price is below the normal price, production tends to be restricted until the price rises.

Normal price tends, under free competition, to equal the cost of production.[1] If the price is above the cost of production (including minimum profit) and competition is free, existing producers will extend their output and new firms will enter the field. Supplies will increase and prices fall. Conversely, if the price falls below the cost of production, the supply will be restricted and the price will rise.

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[1] See above, pp 84–5, for the varying relationship between cost and price according to the length of the period

Under perfectly competitive conditions there can be only one price for an article at a time. Although, as explained in the previous chapter, different units of a commodity may yield varying utilities or entail varying production costs, the fact that they are identical and interchangeable prevents any variation in their price so long as competition is effective. Ordinarily, as has been shown, competition is far from perfect, and normal price, therefore, fails to coincide with cost of production.

Nature of Demand and Supply

(i) **Distinguished from Desire and Stock.** "Demand" must be distinguished from "desire," which merely indicates a wish for something.

Economic demand postulates three conditions—

(*a*) Desire for a commodity;
(*b*) Means to purchase it; and
(*c*) Willingness to use those means.

Demand, therefore, may be described as *effective desire*

In the same way, "supply" must be distinguished from "stock." Supply is the amount of the stock that is actually offered for sale. The more perishable a commodity, the closer is the identity between stock and supply.

Though desire and stock may be regarded without direct reference to price, *there is no such thing as demand and supply considered apart from the price prevailing at a particular time.*

(ii) **Elasticity of Demand and Supply.** The demand for a commodity is said to be *elastic* when a rise or fall in price causes an appreciable fall or rise in demand. It is said to be *inelastic* when a movement in price has comparatively little effect on the demand. More precisely, elasticity of demand is stated to be less than unity when a change in price involves a less than proportionate change in demand, and greater than unity when a resultant change in demand is more than proportionate.

The elasticity of the demand for a commodity is influenced by—

(*a*) The degree of necessity. As a rule, the demand for necessaries of life is relatively inelastic, and for luxuries elastic.

(*b*) The income of the consumer. A person with a small income naturally adjusts his purchases more closely to changes in prices than does a person of larger means.

(*c*) The availability of substitutes. The more readily a consumer can find alternative means of satisfying his wants, the more sensitive is his reaction to price changes.

(*d*) The influence of habit. A person is more likely to vary his orders for goods that have lately entered into his budget than for articles to which he has been for long accustomed.

(*e*) The durability of the commodity. Where an article is comparatively durable, an increase in price may induce a person to make longer use of it.

Similarly, supply is said to be elastic when it varies appreciably with changes in price; inelastic when it is comparatively little affected.

As a general rule an increase in the selling price of a commodity tends to encourage producers to increase their output and to induce new producers to enter the field, while a fall in price exercises a restrictive effect. If, however, the suppliers are anxious to achieve economies by producing on a larger scale for an enlarged market, they may find it advantageous to keep prices low.

As it commonly takes some time for new stocks to be produced, the response of supply to price changes is not usually immediate, though over a long period it may be very elastic. Demand, on the contrary, may expand or contract immediately following a change in the price.

If, however, a rise in price is regarded as a sign of a continuing shortage which may lead to further price increases, prospective purchasers may buy more rather than less, thereby perhaps causing prices to rise more than they otherwise would have done. Similarly, sellers may hold back in the hope of obtaining still better prices. Conversely a fall in prices may, for a time, induce some buyers to defer making purchases in the hope of getting still better terms later, and tempt sellers to place large quantities on the market before prices deteriorate further. Such anticipatory movements are not uncommon in the stock and share market, as well as in markets for commodities that are durable and easily storable. This seeming contradiction of the laws of supply and demand operates, of course, only for a short period, and in no way invalidates the long-term tendency.

Types and Combinations of Demand and Supply

(i) **Alternate Demand and Supply.** Demand is said to be alternate when a choice can be made between commodities that may be used in place of each other There is, for example, an alternate demand for butter and margarine, wool and cotton, electric and gas light, etc. A shortage in the one may cause a rise in price, but not so high as if there were no substitute. Thus, the price of the one will be influenced partly by the price of the other.

Supply is said to be alternate when one class of goods can be produced in preference to another from a single source. Thus, wheat or barley may be grown in varying proportions on a given area of land.

(ii) **Composite Demand and Supply.** Demand is said to be composite when a commodity is required for two or more different purposes (e g. coal used in manufacture and in the household).

Supply is said to be composite when a commodity can be produced from two or more sources (e g. oil from animal, vegetable, or mineral supplies).

(iii) **Joint Demand and Supply.** The demands for two or more things used in conjunction with each other are said to be *joint* or *complementary* There is a *joint demand* for pipes and tobacco, though the ratio of the demand for each is variable. In the demand for steel knives with ivory handles the ratio is more rigid. Also, a commodity may enter into more than one joint relationship

A demand for a commodity involves an indirect demand for the factors that have gone to produce it Thus, the demand for bread involves a *derived demand* for land, seed, labour, machinery, transport, etc.

Commodities are said to be in *joint supply* when they are produced from a single source (e.g. mutton and wool; leather, beef, and milk). The ratio may be variable or fixed.

Influence on Price

These relationships are of great importance in the determination of prices. In the case of joint supply, for instance, while the price of the total product will obviously equal the sum of the prices of the constituent parts, the proportions of the latter to each other will depend partly on conditions of supply, and partly on those of demand. The producers of linseed and flax will aim at getting a gross return equal at least to the cost of the joint production. If the demand for one of the joint products is not sufficient to absorb the supply, the price may be reduced so as to increase the demand. Similarly, the price of the other product may be raised so as to bring the demand into line. Where the goods are produced in a fixed ratio, it follows that their respective prices must be settled at the level at which they are required in the same proportion.

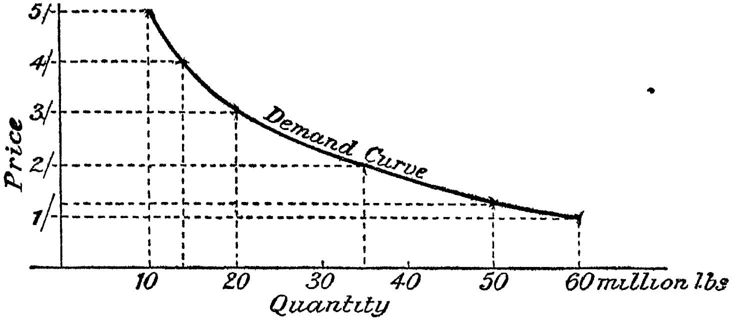
Market Price Determination

The interaction of demand and supply and the fixing of a market price at a point where there is equilibrium may be illustrated by simple schedules Consider an article which might be priced at anything, between 1s. and 5s. per lb., and assume a high elasticity of demand and supply.

Demand

If the	price	were	5s	per lb ,	10	million lb	would be	required
,,	,,	,,	4s	,,	15	,,	,,	,,
,,	,,	,,	3s	,,	20	,,	,,	,,
,,	,,	,,	2s	,,	35	,,	,,	,,
,,	,,	,,	1s 6d	,,	50	,,	,,	,,
,,	,,	,,	1s	,,	60	,,	,,	,,

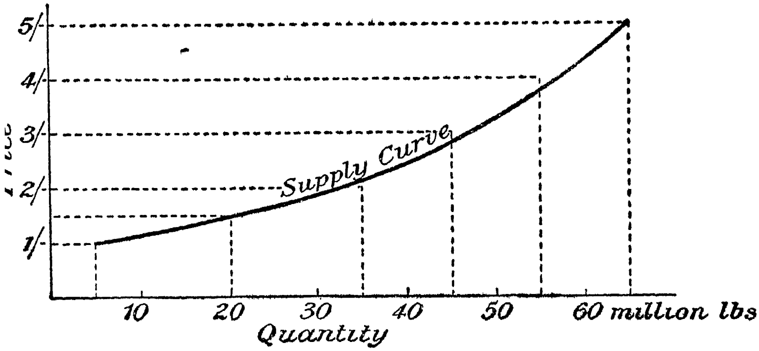
The relationship between price and demand may be depicted graphically:



Regarding now the price from the producer's point of view, we see that the low price of 1s. per lb. would not result in much production. Only those firms whose costs were very low could produce the article at that price and make a profit. If the price were raised, the supply would be increased, partly because the first producers would increase their output, and partly because the number of producers would be increased.

Supply

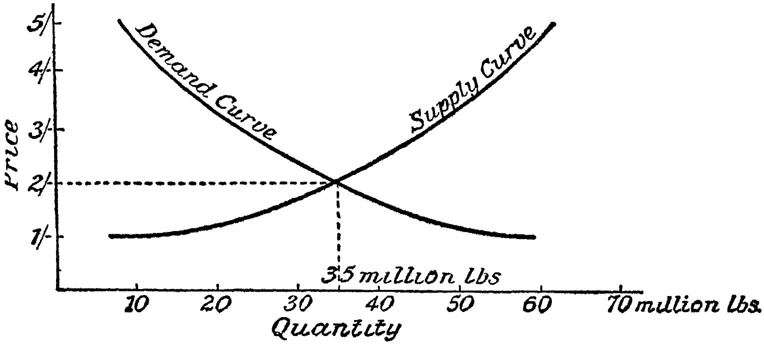
If the price were 1s per lb, 5 million lb would be supplied
" " " 1s 6d " 20 " " "
" " " 2s " 35 " " "
" " " 3s " 45 " " "
" " " 4s " 55 " " "
" " " 5s " 65 " " "



Balancing of Demand and Supply

Combining the tables of demand and supply, we have the following schedule—

Demand	Price	Supply
60 million lb.	1s	5 million lb
50 "	1s 6d	20 "
35 "	2s	35 "
20 "	3s	45 "
15 "	4s	55 "
10 "	5s	65 "



It is easy to see which will be the market price of the article. It cannot be 1s., for at that price there would be 60 million lb. in demand, but only 5 million lb. on offer. Competition among buyers would force the price up. On the other hand, it cannot be 5s., for at that price there would be 65 million lb. on offer, but only 10 million lb. in demand. Competition among sellers would force the price down. At 2s., the demand and supply are equal, and the market price will tend to settle at this figure.

Long-term Changes in Demand and Supply

The above is, of course, an over-simplified statement of the determination of price, for even in a short period the possibility of eventual changes in demand and supply cannot be disregarded. Over a long period the changes can be considerable—

(i) Changes in the total income of the community, thereby affecting the aggregate demand for goods.

(ii) Changes in the distribution of income, thus influencing the nature of the demand—e g. for luxury and necessary goods respectively.

(iii) Changes in the population and in the age composition, and consequently in the character of the goods demanded.

(iv) Changes in tastes and fashions.

(v) Changes in the state of trade. In times of prosperity not only is there an increase in general demand, but the demand for producers' goods tends to grow faster than the demand for consumers' goods. The opposite is true in times of depression.

(vi) Changes in the technique and organization of production.

(vii) Changes due to discovery of new materials and sources of supply.

(viii) Changes in monetary demand. These are considered in Chapter XIII.

The Laws of Supply and Demand

The Laws of Supply and Demand may be summarized in general terms:

(i) *If at a given price the demand for a commodity or service exceeds the supply, the price tends to rise. If the supply exceeds the demand, the price tends to fall.*

(ii) *A rise in price tends to restrict demand and increase supply. A fall in price tends to restrict supply and increase demand*

(iii) *An increase in demand or restriction in supply tends to raise prices. A restriction in demand or increase in supply tends to reduce prices.* (See, however, qualification (*d*) below)

(iv) *The price ultimately tends to the point at which supply and demand are balanced*

(v) *Demand and supply tend to balance at the point at which the marginal utility is equivalent to the marginal cost of production, both as measured in money*

Qualifications of these Laws

(*a*) The above laws express tendencies only, and the implicit condition throughout is that all external conditions remain unchanged.

(*b*) The supply of some commodities is very inelastic or even fixed (e g. land); in such circumstances, a rise in price cannot seriously affect the supply.

(*c*) The demand for some things is very inelastic and a rise in price may not have an appreciable effect on the demand. Indeed, in regard to bread, it has been found that a rise in price is often followed by an increase in the demand from poor families, who make up for the extra cost by economizing in other directions. They find that their reduced income will derive more utility from the purchase of more bread than of other things.

(*d*) With special reference to law (iii), the tendency there stated is observable mainly in the short period, and may in fact be counteracted in certain types of market in the manner explained on page 93 In the long period everything depends on the nature of the returns. "The first effect of increased demand is to raise prices, the ultimate effect is to lower them." If the commodity is being produced under increasing returns (i.e. diminishing costs), an increase in demand will stimulate further production at a diminishing cost per unit, and thus bring about lower prices. A reduction in demand, however, will be followed by a smaller output at an increasing cost per unit, with a consequent rise in price. Where, on the other hand, the commodity is being produced under diminishing returns, extra production means increasing costs, with consequent higher prices, while less production results in smaller costs and lower prices.

Section 2 Monopoly Price

Theory of Monopoly Prices[1]

In a perfectly competitive market, price has been shown to be governed by the marginal cost of production from the one side and by the marginal utility from the other. Undue profits made through selling considerably above cost of production would in the long run invite competitors to enter the field and bring the price down approximately to the cost of production.

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[1] Monopoly prices are usually associated with production and sale, and are considered here in this sense It is possible, however, though not so common, to have a monopoly of buyers e g people at an auction agreeing not to outbid each other, or a combination of producers acting in concert for the purpose of keeping down the price of materials or equipment, or an undertaking by an association of employers not to exceed a certain wage for labour But as the basic principles governing the several forms of monopoly prices are the same, it is not necessary here to enter specifically into the subject of buyers' monopoly

Even where the seller enjoys monopoly powers, he cannot as a rule ignore the possibility of the emergence of competition. He may owe his position to his efficient methods and low costs Or the goods that he sells may be subject to the potential competition of substitutes which are kept off the market only so long as he charges low prices.

But if his monopoly is due to the exclusive ownership of natural supplies, or to some other conditions that make him fairly independent of competition, he is at liberty to charge any price above his cost of production that he chooses, leaving the amount demanded to be decided by the public. Alternatively he can offer any quantity that he wishes, leaving the price to be determined by the market. If he fixes the output, the price at which it sells will not be above the marginal demand price. If he fixes the price, the quantity of supply will be governed by the marginal purchaser. Thus, the power of the monopolist is limited. *He may fix either price or output, but not both.*

The price (and also the profit) will be governed by the nature of the product and the demand, and, though to a smaller extent, by the nature of the returns in production.

(i) Where the article is a necessary and no effective substitute is available, the demand will be relatively inelastic. This will enable the monopolist to raise the price appreciably without much falling-off in demand. Where, on the other hand, the article is not a necessary or can be replaced by a substitute, the demand will be fairly elastic. The monopolist may find that raising the price is accompanied by a serious fall in demand. He tends therefore to adjust it at such a level that the maximum net profit is obtained.

(ii) A reduction in price may cause an increase in demand and in profit, especially if the monopolist is producing under increasing returns (i.e. diminishing costs). Even if the demand were not stimulated in a corresponding degree, the loss from that quarter might be more than balanced by the economies of large production. If, on the contrary, the article is produced under diminishing returns (i.e. increasing costs), it will not pay a monopolist to reduce the price, unless the profit due to the additional turnover more than covers the extra costs of production.

Illustration of Monopoly Price Determination

An illustration of the way in which monopoly prices are determined is given in the table below. It is assumed that the demand is elastic, and that the article is produced under increasing returns.

MONOPOLY PRICE DETERMINATION

Price	Number of Sales	Total Receipts	Cost per Unit	Total Cost	Receipts less Cost—Monopoly Profit
s		£	s	£	£
24	4,000	4,800	22	4,400	400
23	6,000	6,900	20	6,000	900
22	8,000	8,800	19	7,600	1,200
21	*10,000*	*10,500*	*17*	*8,500*	*2,000*
20	11,000	11,000	16½	9,075	1,925
19	12,000	11,400	16	9,600	1,800

The figures in the table clearly show that the price of the article will tend to be 21s., for at that level the largest profit is made.

Monopoly Price Discrimination

It is a common practice for monopolists to discriminate in their charges according to a variety of conditions—

(1) **According to area.** The monopolist may fix price

zones within a country, especially where the transport costs are considerable. Or, while possessing a monopoly at home, he may have to face rivalry abroad, and thus charge lower prices to foreign than to domestic customers. Or, even if he enjoys a monopoly abroad as well, he may find foreign customers less able or willing to pay the prices that are charged in the home market.

(ii) **According to time.** It is not uncommon for a monopolist to vary his charges from one time to another, according to changing circumstances He may begin with low prices, and, having thereby established a market, raise them at a later date. Or he may start with a high price, and as the demand at this level dries up, reduce his charges so as to cater for the next "layer" of demand.

(iii) **According to type of demand.** The monopolist may differentiate in his charges for the same commodity according to the nature of the demand or the capacity of the consumer. He may supply the commodity (e.g soap), in different guises and wrappings, adjusting the respective prices to "what the traffic will bear."

On the other hand, a monopolist may charge uniform rates for unequal services in a manner impracticable under competition. For example, the Post Office charges flat rates for carrying letters within the country irrespective of distance Similarly a local transport system may have a system of fixed fares within given points irrespective of the distance travelled.

PART III

DISTRIBUTION OF THE SOCIAL PRODUCT

CHAPTER VIII

THE NATIONAL INCOME

The Problem of Distribution

THE principles governing the distribution of the social product among the different classes of the community are among the most controversial problems in economics.

In early times the problem of distribution was comparatively straightforward. When a commodity was produced with little or no resort to division of labour, a man could regard it as the specific result of his own efforts. Such raw materials and implements as were used might be his own, and therefore the question as to what were the respective shares going to land, capital and labour did not arise to any serious extent.

When a small number of men assisted each other in (say) hunting for food or in building a hut, the problem of distribution was emerging, but in relatively simple form. It became more intricate as specialization grew and the resources needed for production had to be larger and often more composite and widespread Still further complications were added when the State participated in increasing degree, both by taxation and subvention, in the regulation of incomes.

Computation of the National Income

The National Income or Dividend was defined by Marshall as the "aggregate net product of, and the sole source of payment for, all the agents of production." Considerable advances have been made of late in the computation of the net income of the nation. Census of production and similar reports have furnished a useful foundation, but, since they do not cover every type of economic activity (personal services are a notable omission), they have to be supplemented from other sources. Income and other tax statistics are also a valuable guide, but by themselves they present a very incomplete picture.

Even when the basic figures are known they have to be used with caution so as to avoid pitfalls. There is, for instance, the danger of double counting. Some incomes represent transferences without additional services, and therefore should not be reckoned in the net total.

Thus, if a man makes his widowed mother an allowance out of his earnings it would be incorrect to include his income and that of his mother in the calculation of the total. But if he employs a domestic servant, both his income and the servant's wages should be added. In the one case there is merely a transference of income without any addition to output. In the other the payment is in respect of a specific and additional service.

Similarly, dividends from Government stocks should not, as a rule, be counted in the net national income, unless they are drawn from foreign countries, since they represent internal transferences from taxpayers to stockholders. But if they are payments out of the earnings of public undertakings, such as nationalized railways, they should in that case be reckoned in the total amount.

"Functional" and "Personal" Distribution

A common method adopted in analysing the system of distribution is to take the factors of production in order, and observe the principles governing the share that goes to each. Land, labour, capital and organization receive respectively rent, wages, interest and profits. This method is a convenient one, and makes for simplicity. But it is liable to over-simplification, and the danger then arises of paying too much attention to the *factors* and too little to the *persons* among whom the national product is distributed.

It should be borne in mind that a person often receives an income from supplying more than one of the factors of production A tradesman obtains a return from his labour and also from the capital invested in the various appliances that he possesses. If he owns the land on which his shop is built, he receives some return in the form of rent; while for his enterprise he gets a profit over and above the inclusive sum derived from the other three factors In practice he may not distinguish among the different sources of income, but if his business grows he may find in necessary to do so.

The Authoritarian Factor in Distribution

Up to a point people's incomes may be regarded as valuations placed upon the active services which they perform or upon the passive services of their property. Subject to some important qualifications, the doctrine of value, which was discussed in the previous chapters, can be applied to the general scheme of distribution. Theoretically it might be maintained that the product resulting from the several agents tends under free conditions to be distributed among them in proportion to their marginal contributions.

In the causation of ordinary market values the competitive factor has been greatly weakened in recent times. In the determination of incomes the so-called "frictional" forces are even stronger, particularly in fixing the rewards for personal services. Wages especially are liable to be influenced by custom, or more particularly nowadays by comparative bargaining strength, which is not always related directly to the value of the product. A minimum may be imposed by some statutory body, related more to family need than to productivity. Distribution is becoming increasingly influenced by the public social services, which cause a considerable transference of incomes. Similarly the various subsidies on food and housing have substantially added to the real incomes of the wage-earners, while the heavy taxation thus entailed, together with the continuing high cost of defence and other public services, has a marked restrictive effect at the other end of the income scale. More is said on these modifying influences in Part V.

Other forms of income, too, are subject to authoritarian regulation. Bank discount and interest rates, for example, may be "pegged" at fixed levels. The distribution of company profits may be curbed by deliberatively contrived taxation. Especially notable is the restriction on house rentals below a certain level, which (apart from those payable to local authorities) were "frozen" at the 1939 level for many years. It was not until 1957 that measures for a limited decontrol of rents were put into force

Estimates of Distribution of Income

Before 1941, when it became the practice for the Central Statistical Office of the Government to issue annual statements on the National Income and Expenditure of the United Kingdom, estimates were unofficial and, in the absence of adequate data, necessarily incomplete and speculative. It is still, useful, however, to refer to these earlier estimates, not only for the information which they provide about the circumstances of the time, but also (so far as it is possible to find a common basis for comparison) as a means of tracing the changes in the national income and its distribution over a period of years.

It is convenient to begin with the work of Sir Arthur Bowley[1] whose estimates for the years 1880 and 1913 are summarized in the following table—

THE NATIONAL INCOME, 1880 AND 1913

	1880			1913		
	Number of Incomes, 000's	Income		Number of Incomes, 000's	Income	
		Amount	% of Total		Amount	% of Total
		£ million			£ million	
Wages	12,300	465	41½	15,200	770	35½
Intermediate income under £160[2]	1,850	130	11½	4,310	365	17
Income assessed to tax over £160, excluding wage-earners	620	530	47	1,190	1,030	47½
Totals	14,770	1,125	100	20,700	2,165	100

Bowley reached the conclusions that—

> "The proportion of the national income received as wages diminished [i e between 1880 and 1913] from about 41½ to 35½ per cent, but the receipts per wage-earner increased about 34 per cent
>
> "The proportion received by persons assessed to income tax increased slightly
>
> "The proportion received by the intermediate class increased at least . . from 11½ per cent of the whole to 17 per cent in 1913.
>
> "The average of all incomes was about £76 in 1880 and £104 in 1913, an increase of 37 per cent "[3]

As is shown in the table overleaf the distribution between property and all services appeared during that period to remain constant in the ratio of three to five

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[1] *Changes in Distribution of the National Income, 1880–1913* See also the same writer's *Wages and Income since 1860*

[2] I e the income tax exemption limit that formerly prevailed The "intermediate" class denotes non-wage-earners who were not liable to income tax Subsequently the limit was lowered and large numbers of wage-earners became liable to income tax

[3] The purchasing powers of money in 1880 and 1913 respectively were near enough to afford a reasonable comparison

	1880	1913	Percentage in both instances
Incomes from property	£420 million	£810 million	37½%
Incomes from services of all kinds	£705 ,,	£1,355 ,,	62½%
Total income	£1,125 million	£2,165 million	100%

During and immediately following the 1914–18 war, the money income of the nation greatly increased, though this was, of course, largely offset by the rise in prices. For 1918–19 Lord Stamp estimated the national income to have been about £3,600 million to £3,700 million. For 1919–20, the same authority suggested £3,700 million to £4,100 million.

The ratio, however, in which the total income was apportioned among the different classes did not appear to have undergone any important change.

> "In 1914 some 8 per cent of the total income of the country belonged to a very small fraction, less than one-tenth of 1 per cent of the receivers of incomes The next 22 per cent in amount went to 1 per cent of the number of incomes, and the next 15 per cent of amount of incomes to 4½ per cent of the people receiving incomes. This amounts to 45 per cent of the incomes going to about 5½ per cent of the people with separate incomes Now the money levels of the incomes may alter, but these proportions have remained approximately constant."

In their later work[1] Bowley and Stamp showed that, partly as a result of differential taxation and transfers, the net share going to the wage-earners had in some degree increased—

> "The distribution of income between wage-earners, other earners and unearned income was changed slightly in favour of the earning classes. Manual workers on the average make slightly increased real earnings, and there have also been transfers for their benefit in insurance schemes and other public expenditure. In addition they have the advantage of a reduction of about

[1] *The National Income*, 1924

one-tenth of the working-week This change can be connected with the reduction in the real income derived from house property and investments bearing fixed rates of interest. The indications are that profits as a whole, reckoned before tax is paid, form nearly the same proportion to total income at the two dates Within the wage-earning classes women and unskilled workers have received a substantial real advance in wages, the great majority of skilled workers made at least as much (after allowing for the rise of prices) in 1924 as in 1911 When the full effects of taxation are taken into account the real income available for saving or expenditure in the hands of the rich is definitely less than before the war"

The study of the national income and its distribution was carried over a further decade by Mr Colin Clark,[1] whose estimates for 1911–1935 are summarized in the following table—

DISTRIBUTION OF INCOME, 1911–1935

£s Million

	1911	1925	1927	1929	1931	1933	1935
Home-produced income	1990	4047	4046	4069	3689	3772	4315
Income from overseas	220	310	313	315	200	190	215
Net Government income	148	455	505	516	502	532	570
Home-produced income less Government income	1842	3592	3541	3553	3187	3240	3745
Distribution of Above—							
Wages	728	1437	1492	1486	1366	1362	1520
Per cent	*39 5*	*40 0*	*42 1*	*41 8*	*42 8*	*42 0*	*40 5*
Salaries	288	890	912	944	885	907	937
Per cent	*15 6*	*24 8*	*25 8*	*26 6*	*27 8*	*28 0*	*25 0*
Profits and interest	623	1014	853	821	620	642	949
Per cent	*33 8*	*28 2*	*24 1*	*23 1*	*19 5*	*19 8*	*25 4*
Rents	203	251	284	302	316	329	339
Per cent	*11 1*	*7 0*	*8 0*	*8 5*	*9 9*	*10·2*	*9 1*

In some ways the analysis was more detailed than that of the previous writers. The shrinkage of income from overseas was very evident (especially as 1935 money values represented only about a half of the 1911 values), while the increase in Government income was significant. The ratio of wages remained comparatively constant at about 40 per cent, but that of salaries rose from about 15 to over 25 per cent, bringing the income from employment to over 60 per cent. This increase in ratio was at the expense of profits and interest which declined from 34 to 25 per cent, and also of rents which fell from 11 to 9 per cent.

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[1] *National Income and Outlay*, 1937

> "For 1911 we have the numbers and incomes above £160, corresponding almost exactly, if the change in the cost of living is allowed for, to £250 at the present time, and the numbers and incomes of the then supertax limit of £5,000 . . . Since 1911 we have doubled the relative size of our middle class and have increased by half the number of our plutocrats. The shares of the national income which these two classes have taken have not increased . Allowing for non-personal incomes, we can say that both in 1911 and 1929 the same proportions prevailed—that 10 per cent of the national income was taken by the very rich, 35 per cent by the rich and middle classes, and 55 per cent by the main mass of the population Within the wealthier classes the distribution of income has been somewhat more equal The working and lower-salaried classes do not enjoy a more equal distribution in the sense of their having a greater share of the national income What they do now enjoy is a doubling of their (still slender) chance of promotion to the ranks of the middle-classes and the middle classes enjoy a greater chance of promotion to all ranks of the very rich "

National Income, 1938-58

In recent years official estimates of the national income have been regularly published, based on fuller information than had been available to those making the earlier investigations The first table on p 111 gives the increase in the gross national product, in terms of money, between 1938 and 1958, and the changes in the shares of the main groups The figures show that income from employment rose during this period from 58 to 66 per cent, while gross trading profits of companies increased from 13 to 15 per cent. The proportion of income from self-employment, however, declined from 12 to 9 per cent, and of rent from 9 to 5 per cent

SHARES IN THE GROSS NATIONAL PRODUCT, 1938–58[1]

£ million

	1938	1946	1949	1952	1955	1958
Income from employment	3,022	5,732	7,220	9,112	11,207	13,413
Income from self-employment	647	1,143	1,389	1,502	1,673	1,836
Gross trading profits of companies	690	1,476	1,848	2,186	2,907	3,002
Gross trading surpluses of public corporations and other public enterprises	74	103	259	316	422	492
Rent	470	414	423	563	743	1,038
Allowance for residual error	—	—	30	160	− 37	60
Total domestic income before providing for depreciation and stock appreciation	4,903	8,868	11,160	13,839	16,915	19,841
Less stock appreciation	80	− 125	− 200	50	− 200	20
Gross domestic product at factor cost	4,983	8,743	10,969	13,889	16,715	19,861
Net income from abroad	192	44	160	98	177	269
Gross national product	5,175	8,787	11,129	13,987	16,892	20,130

PERSONAL INCOMES[1]

£ million

	1938	1946	1949	1952	1955	1958
Wages	1,920	3,295	4,425	5,460	6,745	7,770
Salaries	910	1,645	2,160	2,785	3,440	4,320
Forces' pay in cash and kind	66	577	223	342	356	398
Employers' contributions						
National insurance	54	84	197	218	279	398
Other	72	131	215	307	387	527
Total income from employment	3,022	5,732	7,220	9,112	11,207	13,413
Professional persons	118	176	223	230	260	290
Farmers	69	225	343	401	398	439
Other sole traders and partnerships	460	742	823	871	1,015	1,107
Total income from self-employment	647	1,143	1,389	1,502	1,673	1,836
Rent, dividends and interest	1,128	1,255	1,217	1,438	1,734	2,191
National insurance benefits and other grants from public authorities	275	672	745	911	1,116	1,488
Total personal income	5,072	8,802	10,571	12,963	15,730	18,928

[1] *National Income and Expenditure* (Central Statistical Office), 1956–9.

The second table analyses the changes in personal incomes between 1938 and 1958 It shows that wages and salaries quadrupled in money terms, that professional earnings roughly trebled, while rent, dividends and interest barely doubled A final assessment of the relative shares must of course take into account the rise in prices over the years, the effect of which on the various groups were far from uniform, and even more so the very unequal incidence of taxation and social service benefits. More is said on these qualifying conditions in later chapters.

National and Private Expenditure, 1938-58

The first table on p 113 gives a broad picture of the national expenditure, and the main elements composing it, from 1946 to 1958, together with comparable figures for 1938. While the gross national expenditure during the post-war period rose by over 125 per cent, consumers' expenditure just doubled Expenditure by public authorities, still affected in 1946 by war-time limitations, declined for a while, but showed an increase of 50 per cent by 1958 Gross capital formation, which had been greatly curtailed by the war, increased by 300 per cent during these years

The second table indicates the distribution of consumers' expenditure between 1938 and 1958 in the terms of current market prices Total money outlay more than trebled over the period, in keeping, more or less, with the general rise in prices. The expenditure on food and tobacco rose by slightly more than the average. That on alcoholic drink, household goods and clothing kept pace with the total That on housing little more than doubled, due largely to the severe control of rentals throughout nearly the whole of the period

Figures of this kind over a period of time, however, should be interpreted and compared with care It must

NATIONAL EXPENDITURE, 1938–58[1]
£ million

	1938	1946	1949	1952	1955	1958
Consumers' expenditure	4,394	7,159	8,878	10,635	12,865	14,925
Public authorities' current expenditure on goods and services	772	2,291	1,979	2,899	3,213	3,742
Gross domestic capital formation [2]						
Fixed capital formation	656	925	1,603	2,131	2,841	3,516
Value of physical increase in stocks and work in progress	—	– 51	65	50	300	50
Total domestic expenditure	5,822	10,324	15,525	15,715	19,219	22,233
Exports and income received from abroad	976	1,496	2,689	4,053	4,568	5,135
Less Imports and income paid abroad	– 1,038	– 1,869	– 2,626	– 3,908	– 4,618	– 4,607
Less Taxes on expenditure	– 622	– 1,551	– 1,984	– 2,291	– 2,623	– 3,031
Subsidies	37	387	525	418	346	400
Gross national expenditure at factor cost (Gross national product)	5,175	8,787	11,219	13,987	16,982	20,130

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[1] *National Income and Expenditure*, 1956–59

[2] I e amount available for investment Actual investment may be considerably less

CONSUMERS' EXPENDITURE[3]

	1938	1948	1950	1952	1954	1956	1958
Food	1,285	2,245	2,699	3,246	3,778	4,351	4,672
Alcoholic drink	285	826	761	802	818	898	941
Tobacco	177	764	766	821	855	935	1,031
Housing	518	745	793	904	1,053	1,124	1,374
Fuel and light	197	324	353	421	486	590	677
Durable goods	234	353	481	576	844	905	1,147
Other household goods	54	262	319	345	381	419	451
Clothing	446	902	1,063	1,083	1,174	1,339	1,383
Books, newspapers etc	—	133	144	167	180	208	233
Miscellaneous recreational goods	—	103	109	120	132	147	161
Chemists' goods	—	121	135	153	169	198	224
Other goods	—	145	137	152	163	187	206
Running costs of vehicles	—	62	117	159	198	278	342
Travel	167	357	362	423	444	494	521
Communication services	29	58	62	72	81	102	132
Entertainments	64	180	177	186	189	198	193
Domestic service	—	110	98	95	95	95	92
Insurance and other services	407	720	706	799	868	966	1,031
Income in kind	17	49	43	68	69	64	56
less Foreign tourists' expenditure in U K	– 43	– 33	– 65	– 104	– 123	– 150	– 163
Consumers' expenditure in U K	4,360	8,426	9,260	10,488	11,854	13,348	14,704
Consumers' expenditure abroad	34	94	116	147	169	194	221
Total	4,394	8,520	9,376	10,635	12,023	13,542	14,925

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[3] *Annual Abstract of Statistics*, 1959 (Figures for 1938 not fully available or wholly comparable)

be borne in mind that the total number of consumers increased between 1938 and 1958 from 48 to 52 million, and that even within this short period the age distribution underwent some change, thereby affecting the pattern of consumption Also during these years there were some significant changes in standards and qualities

It is important too to maintain a distinction between the national cost of consumers' goods and the actual cost to consumers Some goods carry a subsidy while others bear a tax. The national cost of tobacco, for instance, is about one-quarter of the cost to the consumer, and of alcoholic beverages about one-third In total the national cost of the various goods and services is estimated to be approximately four-fifths of the cost to the consumer.

The Distribution of Capital

The distribution of income is closely bound up with, and the inequality largely the result of, the distribution of capital. Inequality in capital ownership is even more marked than that of incomes. Those with small incomes from services obviously find difficulty in accumulating capital possessions As incomes grow the proportion required for normal living expenses diminishes, and the ratio as well as the amount available for savings increases. The cumulative effect of capital ownership is to increase the income still further and to accentuate the inequality of distribution. This inequality, however, as already shown, is materially reduced by taxation which falls more heavily on large than on small incomes and estates. This aspect of taxation is considered more fully in Part V.

It is a more difficult matter to estimate the value and the manner of distribution of the national capital. There is greater variation in the values of capital (including for this purpose all forms of property) than in incomes, and a great deal of wealth must inevitably escape computation. Obviously the most useful source of information is to be found in the returns of death duties, though these do not give a complete picture of the situation. (For example, much wealth is corporately held and does not enter into these returns. Also a substantial amount is passed on during life-time in order to avoid death duties.)

Messrs. Daniels and Campion[1] made an analysis of the distribution of capital in England and Wales during 1924–30. They took all persons of 25 and over, and made separate estimates for males and females. They found that less than 1 per cent of the males, i e under 200,000, owned over £10,000 each, or between them more than 60 per cent of the wealth owned by males. Only 2·4 per cent of the males owned more than £5000, and 8 per cent more than £1000 each. Over 70 per cent of the males, representing about 7½ millions, owned less than £100 each, or under 5 per cent of the total property. The estimated distribution among females was roughly similar.

The same authors also made an analysis of the distribution of capital by age groups, disregarding sex. They found that of every hundred people between 25 and 34, 86 had less than £100, 12 had between £100 and £1000, 1·5 had between £1000 and £5000, and 0·5 had more than £5000. (The percentages here are only approximate) As one would expect, the possession of property increased with years. In the 45–54 age group, 74 per cent had less than £100, 18 between £100 and £1000, 5 between £1000 and £5000, and 3 over £5000. In the 65–74 age group, 69 per cent had less than £100, 19 between £100 and £1000, 8 between £1000 and £5000, and 4 over £5000.

Particulars of the distribution of capital among persons of 25 and over in the various capital groups, as estimated by the above writers, and a comparison with the corresponding estimates for 1911–13, are given in the following table—

DISTRIBUTION OF CAPITAL
1911–13 and 1924–30
England and Wales

	1911–13		1924–30	
	Number	Percentage	Number	Percentage
TOTAL	000 18,745	100	000 22,336	100
£100 or less	16,218–16,549	86 5–88 3	17,052–17,562	76 3–78 6
£100–1,000	1,638–1,894	8 7–10 1	3,468–3,862	15 5–17 3
£1,000–5,000	397–453	2 1–2 4	949–1,035	4 2–4 6
£5,000–10,000	77–86	0 4–0 5	177–192	0 8–0 9
£10,000–25,000	54–60	0 3	116–125	0 5–0 6
£25,000–100,000	25–28	0 1	54–58	0 2–0 3
Over £100,000	5–6	0 03	10–11	0 04–0 05

Estimates of the distribution of capital in the period preceding and following the Second World War are contained in the next table.

DISTRIBUTION OF CAPITAL[1]
1936–38 and 1946–47
England and Wales

	1936–38		1946–47	
	Number	Percentage	Number	Percentage
TOTAL	000 25,502	100	000 27,804	100
£100–1,000	6,317	24 75	10,948	39 38
£1,000–5,000	1,764	6 92	3,221	11 58
£5,000–10,000	470	1 84	756	2 72
£10,000–25,000	239	0 94	373	1 34
£25,000–100,000	83	0 33	122	0 44
Over £100,000	13	0 05	16	0 06

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[1] *Oxford University Institute of Statistics, Bulletin*, Dec , 1950

The concentration of capital has in recent years been modified to some extent by heavy death duties. The following table gives the number and capital value of estates in Great Britain subjected to these duties, and shows the decline in the largest estates in recent years

ESTATES SUBJECTED TO DEATH DUTIES[1]

	Number of Estates			Capital value £m		
	1938–39	1947–48	1957–58	1938–39	1947–48	1957–58
Total	152,714	62,050	60,619	553 6	802 9	780
£1,000–5,000	37,623	not available[2]		92 0	not available[2]	
£5,000–10,000	8,504	15,149	19,157	63 4	113 5	137 3
£10,000–25,000	6,066	10,725	11,944	96 2	171 7	185 2
£25,000–100,000	2,974	4,872	5,021	138 4	222 7	225 8
Over £100,000	497	790	578	119 7	191 4	139 1

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[1] Board of Inland Revenue

[2] Exemption limits were raised following 1946 (£2,000) and 1954 (£3,000)

Causes of Inequality in Capital Ownership

As already stated, the distribution of income is closely connected with the ownership of capital. Although the causes of inequality among incomes will be examined later, some of the factors bearing on the distribution of capital especially may be mentioned here.

(1) Differences in Ability

In an economic society in which reward is determined largely by productivity or value of service, those who possess natural abilities of a high order will be at an advantage. It is true, of course, that the possession of talent alone may not be sufficient; that in the absence of favourable circumstances it may not be sufficiently rewarded. The principle of remuneration according to value of service, however, is still predominant in most forms of society, and differences in personal ability therefore are reflected in the respective incomes.

(ii) Differences in Fortune and Opportunity

The element of "luck" cannot be ignored, though it is liable to be exaggerated. The chance possession of a particular ability or of some material factor of production for which a demand arises tends to enhance the income of the owner. But more important is the inequality of opportunity which is still prevalent despite the strides that have been made in public education and in the opening-up of a number of professions and pursuits to which entrance was formerly very restricted. Until recently only one boy out of a thousand attending public elementary schools reached a university, as compared with one out of ten in the top income groups Similar inequalities occur in the higher branches of industry and commerce.

(iii) The Institution of Inheritance

The law of inheritance, based on the freedom of bequest, is of particular importance in perpetuating and increasing the inequality in the possession of capital. Mr. J. Wedgwood,[1] in an investigation into the accumulation of the national capital (1885–1912), estimated that two-thirds of the total represented inherited wealth and one-third savings. In the same way as a person with a large income is able to save a greater proportion than one with a small income (for as income increases the expenditure on ordinary needs normally occupies a smaller percentage of the total), so a person with large capital possessions is in a better position to save and make further accumulations He is also able to provide better opportunities for his children The growth of death duties in recent years, however, amounting now to more than half of the value of the largest estates, has served not only to check the cumulative influence on incomes, but to reduce the inequalities in the system of distribution as a whole.

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[1] *The Economics of Inheritance*

CHAPTER IX

WAGES

Section 1. *The Payment of Wages*

THE problem of wages is very comprehensive. For convenience it may be examined under the following main heads—

(i) The share of the national dividend that goes to labour. This involves the study of *general wages.*

(ii) The variation in wages in different occupations, and also in different countries. This involves the study of *relative wages.*

(iii) The methods of remuneration.

(iv) Labour organizations and their effects on wages.

Nominal and Real Earnings

Nominal Income, whether in the form of wages or anything else, represents one's revenue in terms of money. But this, without reference to the level of prices, affords no criterion of its real worth

Real Income is the purchasing-power of the money income. It is dependent on the prevailing level of prices, which may vary from time to time, or place to place

Real Earnings are governed by—

(*a*) Variations in the level of prices.

(*b*) Payment in kind (e g. the agricultural labourer's cottage, the miner's cheap coal)

(*c*) Any additional earnings in one's spare time.

(*d*) Working hours and conditions, holidays with pay, etc

(*e*) Character of work and effect on duration of working capacity (e.g. leadworking, metal-grinding, service in tropical countries, all of which, owing to periods of sickness or difficulty in continuing after middle life, may reduce the net earnings).

(*f*) Pleasantness of and social prestige attached to the work. Some occupations carry a social position of which account is taken in reckoning the net gains of employment.

(*g*) Regularity of employment. Some trades are seasonal (e.g. agriculture, building, etc); others are irregular (e.g. fishing, etc.). The real wage depends on the total earnings over a period.

(*h*) Scope for promotion A man may be willing to work for a low wage for a time provided there is reasonable opportunity of advancement later.

Thus, even if competition were free and mobility perfect, actual wages, though they would draw nearer to equality, would not reach a uniform level The equalizing tendency of competition would be in the direction not of monetary rewards but of *net advantages.*

Nominal and Real Labour Cost

In the same way as the worker has to distinguish between his nominal and real income, so the employer, from his point of view, distinguishes between *wages* and *labour cost* The former represents the sum paid out, the latter the actual worth of the work done The real labour cost depends partly on the intensity of the effort which a worker applies to his task, and partly on the conditions of employment and the quality of management An efficiently organized concern may pay relatively high wages yet enjoy relatively low labour costs.

Earnings and Hours

Low wages may adversely affect a worker's physical capacity, and an improvement in rates may therefore lead to a proportionately greater increase in output, resulting in a net reduction in labour costs Similar considerations apply to excessive working hours Up to a point, a contraction of the working week may not cause a decline in output; in certain circumstances it could even have the opposite effect

In recent years labour conditions over a large field have so improved that neither an increase in wage rates nor a reduction in hours has had such a specific effect on output As real incomes have on the whole tended to rise, many workers have been inclined, in effect, to buy more leisure

On the other hand, with a reduction in the number of hours in the basic working week and the higher rates paid for hours in excess of this number, the working of overtime in some industries has become a regular practice

The growing use of machinery has helped to increase the productivity and earnings of labour, and to shorten the basic working week It has also been conducive, where other conditions were favourable, to the introduction or extension of shift-working, thereby spreading the capital and other overhead charges over a larger output and reducing unit costs

The table on p 122 indicates the increase in money earnings (as distinct from wage rates) and the changes in the hours worked (including overtime) between 1948 and 1959 Changes in the index of weekly wage rates since 1952 are also given During these years retail prices rose considerably (see p 204) but money earnings in a number of industries increased at a somewhat greater rate

Peculiarities of Labour Supply

Though labour is not a commodity, in the popular sense, it is, up to a point, bought and sold in the market in the ordinary way There are, however, certain peculiarities—

(1) A man's labour is part of himself, and therefore, different from material commodities, cannot be delivered except in person. The worker, moreover, is concerned

AVERAGE WEEKLY EARNINGS AND HOURS IN CERTAIN INDUSTRIES[1]

At April in each year

	Earnings (Including overtime)				Hours (Including overtime)	
	1948		1959		1948	1959
	s	d	s	d		
All industries included	117	4	222	6	45 3	48 0
Mining and quarrying (excl coal)	126	8	245	2	46 2	50 0
All manufacturing industries	116	10	220	6	44 9	47 6
Non-metalliferous mining manufacture	120	8	227	6	46 6	49 7
Chemicals and allied trades	119	9	233	1	45 5	47 9
Metal manufacture	146	4	270	2	46 6	46 6
Engineering, shipbuilding and electrical goods	128	2	237	4	45 7	47 8
Vehicles	140	9	264	10	45 1	47 4
Other metal goods	116	8	219	7	44 3	47 5
Precision instruments, jewellery, etc	115	6	205	2	43 6	46 0
Textiles	94	4	174	0	44 4	47 9
Leather, leather goods and fur	109	0	185	9	44 1	47 1
Clothing	86	5	148	1	44 4	44 8
Food, drink and tobacco	102	6	192	6	46 0	48 8
Manufactures of wood and cork	114	6	214	6	44 7	46 6
Paper and printing	114	10	235	3	44 1	47 2
Other manufacturing industries	113	4	211	6	45 3	48 3
Building and contracting	123	6	241	10	46 9	49 2
Gas, electricity and water	126	1	227	10	46 4	48 6
Transport and communication	126	7	246	11	47 7	50 8
National and local government service	106	3	189	5	44 3	45 9

INDEX OF WEEKLY WAGE RATES[1]

Monthly averages

Old series, 30th June, 1947=100				New series, 31st Jan , 1956=100			
1952	1953	1954	1955	1956	1957	1958	1959 (Aug)
130	136	142	151	105	110	114	117

[1] Ministry of Labour

with the conditions in which his labour is utilized as well as with the actual price.

(ii) Labour withheld means, as a rule, so much labour power lost to the community. It cannot be kept back like some forms of merchandise to await a better market. Labour may thus be likened to a perishable commodity.

(iii) In the absence of an effective trade union, a labourer is usually at a disadvantage in bargaining with an employer. His staying-power is comparatively weak, whereas the employer is equal in bargaining power to all the workers in his pay. One of the principal functions of trade unions is to substitute collective for individual bargaining and so remedy this disadvantage

(iv) An improvement in wages does not necessarily result in an increase in labour supply. As implied above, higher wages may induce workers to "buy more leisure."

(v) Different from ordinary commodities, the growth of new supplies of labour is very slow. Similarly, if supplies become redundant, they cannot be quickly reduced.

Wages Systems: Time and Piece Earnings

Wages are paid in a variety of ways, but the principal methods are according to Time or Piece, or a combination of both In the calculation of one type of rate, however, some reference to the other is unavoidable The advantages and drawbacks of time and piece rates respectively may be summarized.

(i) Time Earnings

ADVANTAGES. Time earnings are usually considered to be preferable—

(*a*) Where the work is not standardized and is difficult to measure (e.g. repair work).

(*b*) Where the work needs great care and minute attention.

(*c*) Where delicate and expensive machinery is used. In both (*b*) and (*c*) piece rates, if they led to "scamping" of the work, might cause serious loss.

(*d*) Where intervals of temporary idleness are inevitable (e.g. outdoor work dependent on weather conditions)

(*e*) In that the worker is in general assured of a more regular, though not on the average such a high, income.

DRAWBACKS The critics of time earnings contend that—

(*a*) In the absence of safeguards, work may become slack.

(*b*) There is no inducement to effort if the best and worst workers in one grade receive the same remuneration.

(*c*) It is difficult, therefore, to select the superior men for higher-class work.

(ii) Piece Earnings

The advantages and drawbacks of piece earnings have to a large extent been implied, but may be briefly recapitulated

ADVANTAGES. Payment by results—

(*a*) Adds an incentive and tends to increase output.

(*b*) Distinguishes the superior workers.

DRAWBACKS—

(*a*) The worker who produces the largest quantity is not necessarily the most efficient.

(*b*) Piece rates cannot be satisfactorily applied to all kinds of work.

(*c*) Jealousy may be fostered between workpeople.

(*d*) Standard time rates may be undermined

(*e*) The worker's income may be so irregular as to make for instability of the family budget.

(*f*) Undue speeding-up and intensive labour may adversely affect the worker's health.

The Guaranteed Week

With the growing mechanization of industry it has become increasingly difficult to evaluate individual tasks and determine the worker's remuneration accordingly The extension of "automation" over an ever-widening field serves to underline the limitations of the traditional forms of time- or piece-rate fixing The practice is growing therefore of guaranteeing the worker a basic weekly wage, and supplementing this with a payment variously calculated according to the circumstances of the industry

Other Methods of Remuneration

Other wages systems, some of them closely related to those already noted and aiming in effect at combining some form of guaranteed reward with an inducement to greater effort, may be briefly noted

(i) **Premium Bonus Systems.** The general method of these systems, of which there are several kinds, is to determine a standard output, for which a guaranteed wage will be made, and to pay a premium, suitably calculated, for all production in excess of this standard. Frequently, these systems are combined with (ii)

(ii) **Efficiency Systems.** Time and motion study, usually associated with "scientific management," is commonly, though not necessarily, at the basis of such systems Under the *time study* procedure a task that has to be priced is given to a "good average man, not a specially skilled workman, but one well above the ordinary run of the shop," or to a number of such men The average time taken forms the basis of the *efficiency rate*, which, as in the premium bonus systems, allows a percentage for output in excess of the agreed standard The method of motion-study aims at regulating the motions and minute operations of the worker in such a way that the work is done in the minimum time and with the minimum number of motions.

Scientific management and its attendant systems of remuneration have encountered a certain amount of opposition. The critics object to the time-study method on the ground that the "good average man" may be well above the average, and that the scales laid down by the rate fixer may be unrealistic and unfair. They fear that motion-study may pay too little attention to the individual, regarding him in effect as little more than a machine It must be added, however, that many of the crudities and abuses of the earlier systems have been removed, and that the principle is now widely accepted

(iii) **Sliding Scales According to Cost of Living.** The practice of adjusting wages to variations in the official cost-of-living index number, published by the Ministry of Labour (as distinct from the wholesale prices index number, issued by the Board of Trade), was largely developed in the 1914–18 war and retained in many trades in the subsequent years. In the 1939–45 war it was again found to be a convenient means of meeting variations in living costs. The system, however, has certain defects—

(*a*) Index numbers that are calculated by reference to so-called typical household budgets are unlikely to reflect with any accuracy changes in the cost of living of the numerous families or individuals who depart from the average.[1]

(*b*) The system is liable to be too rigid and to fix the wages of different grades of workers on too stereotyped lines.

(*c*) A method of remuneration which does not specifically take into account the productivity and wage-paying capacity of the industry is unrealistic and apt, in times of depression, to break down.

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[1] See below, pp 201 *et seq* , on the calculation and limitations of index numbers

(iv) **Profit-sharing and Co-partnership.** Various profit-sharing and co-partnership schemes have been devised with the object of broadening the relationship between employer and employed.

Profit-sharing takes the form of an arrangement between an employer and the workpeople under which the latter receive, in addition to their wages, a proportion usually fixed in advance of the profits of the undertaking.

Co-partnership is an extension of profit-sharing schemes. As a rule the worker is enabled to accumulate his bonuses and exchange them for shares in the employing company, though there are some systems which allocate shares to workers without a preliminary distribution of a profit-sharing bonus. Occasionally provision is made for representation of the workers on the board of directors.

Profit-sharing and co-partnership schemes have not made a wide appeal to individual or corporate owners of businesses. Nor have they gained much favour in labour circles. It is commonly averred that participation in the profits of a concern, even if it does not tend to reduce the actual wage bill and so nullify any financial advantage, may undermine the loyalty of the workers to their own organization, and in the end be against their true interests.

Minimum Wage Legislation

In a number of industries trade unions have in the past been either non-existent or too weak to negotiate wages rates for their members In consequence the State has intervened and passed protective legislation.

The Trade Boards Act, 1909, was the first legislation in this country for the establishment of a minimum wage. Government Trade Boards, equally representative of the workers and employers in particular trades, together with a number of State nominees, were empowered to inquire into the conditions of remuneration and to fix minimum rates that would have the force of law. Boards were immediately set up in four badly paid trades, and in 1913 four more were brought within the scope of the Trade Boards Act.

The Trade Boards Act, 1918, which was wider in scope, was applied to several more trades, not as underpaid and unorganized as those first catered for. The rates which the new Trade Boards laid down were on the whole higher than those specified by the earlier Boards Within a few years wages boards under the Act were set up in forty-eight trades, which together employed over 1,100,000 workers.

The Wage Councils Act, 1945, repealed and replaced the Trades Board Act of 1918. The new Act empowered the Minister of Labour and National Service to set up a Wages Council in any industry with powers to propose regulations fixing remuneration and settling holiday conditions By this Act the existing Trade Boards became Wage Councils.

In addition to general legislation of this kind there are various Acts dealing with particular industries Thus, the Agricultural Wages Act, 1924, provided for the establishment of a National Agricultural Wages Board and for County Agricultural Wages Committees. The peculiar conditions in the agricultural industry, however, cause the minimum rates to be much below those paid in the towns, though since 1939 agricultural wages have greatly improved Similarly the Catering Wages Act, 1943, permits of minimum wages and conditions for employees in hotels and restaurants In addition a number of special schemes have been instituted, such as in the coal industry, in which the miners can earn a substantial bonus over and above the basic rate, and in the ports, where dockers, who used to suffer greatly from casual employment and irregular earnings, are now assured of a minimum income.

Unemployment Insurance and Wages

Minimum rates of wages are influenced to some extent by the scales of benefit under the national insurance scheme. The payments are deliberately fixed at a lower level than the average wages, but they are liable to have a bearing on poorly remunerated trades that are not covered by wages legislation. An anomaly tends to arise from the fact that unemployment benefit is determined on a basis of need, whereas wages are more directly related to the value of the product. Hence in badly paid trades a man with a large family may receive as much when unemployed as when he is in a job Anomalies of this kind only serve to strengthen the movement for a system of remuneration that bears a closer relationship to the needs of the workers.

Effects of Minimum Wage Legislation

The economic consequences of minimum wage legislation are by no means uniform, for each trade has its special conditions and problems For example the elasticity of the demand for the product will largely determine whether the employers can raise prices and thus transmit the higher labour charges to the consumer. If not, and there are no other means of meeting the extra cost, either the employer must bear part or whole of the wage increase, or, if the profits are already at the minimum, some of the employees, especially the less efficient, are liable to be dismissed.

Some of the conditions resulting from the establishment of a minimum wage may be noted

(1) High-grade workers are less likely to move to other employments, or may be attracted from worse paid trades.

(ii) Less efficient workers, whose productivity does not warrant the minimum rate, may be dismissed.

(iii) Installation of labour-saving machinery may result in further dismissals On the other hand, the statutory minimum may serve as a stimulus for employers to improve their methods of organization and management, with the result that they may find it possible not only to maintain employment but to pay wages above the minimum rates.

(iv) Where the previous wages have been insufficient to maintain a worker in a standard of full efficiency, an increase in earnings may result in greater output and thus pay for itself.

Section 2. Theories of Wages

The Subsistence Theory

Though the earlier theories of wages have been largely superseded, certain of them merit brief reference

In its early form the subsistence theory stated that if workers received more than a bare living, population would tend to increase, competition for employment would become keener, and the wage would be dragged down again to the bare subsistence level. Alternatively, a fall below the subsistence level would cause a reduction in population and eventually lead to a rise in the wage. The theory was in accord with the cost of production doctrine of value and the theory of population held by the Classical School of economists, in that subsistence was regarded in effect as the cost of producing labour.

Lassalle, the German socialist, in reformulating the subsistence theory, contended that, under a capitalist system, the employers and the landowners appropriated the whole of the social product in excess of the minimum amount necessary to keep the workers alive.

The appalling conditions in France and Britain during the eighteenth and early nineteenth centuries seemed to bear out the doctrine. Even to-day it would appear under some conditions to contain more than an element of truth In some parts of the world (e g. China and India) the position of the mass of the people has not been measurably improved despite the increase in the total wealth.

Criticism of Subsistence Theory

(i) The theory rests on the false premise that an increase in wages necessarily leads to an increase in the population; this is contrary to fact

(ii) Real wages have generally advanced during the past hundred years or so, and the consumption of comparative comforts and luxuries by the wage-earners generally has steadily increased.

(iii) It does not explain the inequality of wages in different trades and countries.

(iv) Like the cost of production theory of value it attempts an explanation mainly from the side of supply with insufficient reference to conditions of demand.

The Wages Fund Theory

The Wages Fund Theory succeeded the previous doctrine, and is usually associated with J S. Mill, who stated.

(1) "That industry is limited by capital, but does not always come up to that limit, while the increase of capital gives increased employment to labour without assignable bounds" (*Principles of Political Economy*, Book I, Chap. V, Sects 1, 2, 3)

(2) "It is not, however, all capital, i e all wealth saved and appropriated to reproductive employment, which constitutes the wages fund of a country, but that part only which is circulating as distinct from fixed, i e that part only which is destined for the purchase of labour" (Book II, Chap XI, Sect. 1)

(3) This being so, "wages depend mainly upon the supply and demand of labour, or as it is often expressed, on the proportion between population and capital With these limitations of the terms, wages not only depend on the relative amount of capital and labour, but cannot, under the rule of competition, be affected

by anything else Wages, meaning of course the general rate, cannot rise but by an increase of the aggregate funds employed in hiring labourers, or a diminution in the number of competitors for hire, nor fall, except either by a diminution of the funds devoted to paying labour, or by an increase in the number of labourers to be paid" (Book II, Chap. XI, Sect 1.)

In short, it was contended that at any time there is a fixed amount of capital to be devoted to labour, this is the Wages Fund, and represents the *demand.* There is also at any time a fixed number of labourers who must work whatever the rate of wages, this represents the *supply* of labour The fund is distributed among the labourers under the rule of competition. As in the subsistence theory, it was held that any rise in general wages would increase the population, leading ultimately to a fall in wages.

According to this theory, wages in one industry can, in general, rise only at the expense of wages in another industry Should wages in one trade be unusually high, an inflow of labour would be induced from other trades, resulting in a contraction of the rates. Should *all* wages rise for a time, the gain would be at the expense of profits, capital would be driven out, the demand for labour would therefore be reduced, and wages would inevitably fall again.

The wages fund doctrine was widely held in the middle of the nineteenth century, and was frequently employed as an argument against trade unionists and others who were pressing for improvements in the remuneration of labour, whether of particular sections or as a whole.

Mill later modified his theory, and eventually had to renounce it.

Criticism of Wages Fund Theory

(i) Wages may be increased without necessarily being at the expense of profits. The theory confuses the nominal and the real cost of labour, and pays insufficient attention to the possibility of higher wages being accompanied by greater efficiency, resulting in an increase in the social dividend.

(ii) A fall in profits does not immediately drive capital out of an industry, particularly where much of it is fixed and specialized.

(iii) Wages may be high in one trade and low in another, yet the immobility of labour be strong enough to prevent a flow from the worse to the better paid trade. The theory credits the workers with a greater adaptability than they possess

(iv) It does not explain inequality of wages in different trades.

(v) It is disproved by facts. Wages are often high in new countries where the amount of capital is small and population is increasing. In times of good trade wages and profits both increase—obviously the result of a greater productivity, for which insufficient allowance is made in the wages fund theory.

Productivity Theories

According to the Productivity Theories wages are paid not out of a fixed fund, but rather from a "continuous stream," the volume of which is variable within wide limits. Stress is laid on increased efficiency and output, the wage being proportionate to the worker's productivity. These theories are therefore not so discouraging as those which held that a rise in one man's wage must ultimately be at the expense of another.

An early stage in the development of the productivity doctrine was the Residual Claimant Theory, according to which the worker was regarded as the final claimant on the net product To quote Jevons "The wages of a working man are ultimately coincident with what he produces, after the deductions of rent, taxes, and the interest on capital." The latter forms of income, however, are by no means so fixed or pre-determined as the theory suggested. The fact that the residual claimant notion has been applied in varying degree to other agents of production only underlines the limitations of the doctrine.

Higher and Lower Limits to Wages

The supply of labour is practically fixed within a short period, and, as "labour will not keep," it must be offered for sale The *minimum* price for labour that can be accepted, however, is the cost of subsistence. In this case, therefore, the theory of value as applied to wages must be qualified. When the supply of water is practically unlimited, the price falls almost to nil; but if the supply of labour were unlimited, wages could obviously not fall below the level set by subsistence.

From the point of view of the demand for labour, it is obvious that the *maximum* that will be paid in wages is determined by the value of the worker's contribution to the product. It is maintained in the productivity theories that there is a specific product attributable to labour, capital and land, and that each tends, under free competition, to receive a reward corresponding to its own contribution to the total.

The *Principle of Substitution* is very important in this connection. The entrepreneur aims at employing the various factors in just those proportions that will result in the maximum productivity. If the wage demanded is higher than the value of the specific product of labour, the result must be either a dismissal of some workers or (unless an effective substitution of machinery or an improvement in organization is possible) a stoppage of production altogether.

Wage rates nowadays are settled in an increasing number of industries by negotiations between trade unions and employers' associations, and are fixed over a large field as well by Wage Councils and other statutory authorities For this and other reasons, the early theories of wages have lost much of the validity which they may have formerly possessed

For the present, it may be stated that **wages may vary between the minimum set by the cost of subsistence and the maximum set by the productivity of the worker, according to the bargaining strength of the workers and employers respectively.**

The Marginal Productivity Theory of Wages

The Marginal Productivity Theory is an application of the general marginal theory of value previously outlined. A similar line of argument is followed. Suppose that an employer is taking on men for a particular grade of work. After a certain point, owing to diminishing returns or to a fall in the selling price of the product consequent on an increased supply, or to both, a stage is reached when the last man taken on yields no more than the wage paid, i e it will not pay the employer to take on any more men. Since the men are by hypothesis identical and can be interchanged without any variation in the quantity or quality of the product, the employer will not pay a rate of wages higher than that measured by the output of the marginal man, or rather (for reasons which have already been explained in Chapter VI) by the value of the marginal product.

Where machinery or other capital instruments can be employed, with scope for variation in the number of workers, the employer is constantly comparing the specific productivity of units of labour and capital respectively. He tries to estimate the additional product that will result from taking on an extra man or utilizing an extra unit of capital. If competition is effective, the marginal productivities of both agents will tend to equality.

The marginal supply price of labour is not so easy to define, because of the peculiarities, already noted, governing the supply of labour. Earnings cannot over a period fall below subsistence level, and if an employer, or an industry as a whole, cannot afford to pay wages even at this low level, production, in the absence of any subsidy, must stop Also the supply of labour does not, like that of ordinary commodities, vary appreciably with the price obtained If wages fall, the supply of labour does not necessarily diminish If they rise, the supply cannot be quickly increased Indeed, as we have already observed, an increase in wages may lead to a reduction in hours or intensity of effort.

Subject to such qualifications, it may be stated that, in accordance with the general theory, the rate of wages tends under free conditions to be determined at the point at which the marginal conditions of demand and supply are in equilibrium.

"Wages are the Discounted Marginal Product of Labour." A refinement of the marginal productivity theory is the application of the conception of a discount. Production takes time, and workmen have not the means to wait until their product is marketed and paid for. Employers advance these means during the period of production, but naturally have to take the loss of interest into account in computing their wage-paying capacity. Hence the actual wage is said to be equal to the value of the marginal product *less* the interest on the wage from the time it is paid to the time when the employer receives payment for the goods produced.

Limitations of the Marginal Theory of Wages

While the marginal productivity theory approximates to the truth more closely than the earlier theories, certain qualifications have to be made—

(i) The theory postulates a degree of free competition and mobility not to be found in everyday life. It is not the case that if an employer can pay more, he will always be driven by competition to do so. Similarly, a worker may be receiving more than he would be prepared to accept under less favourable conditions "Economic friction" may be too strong to permit of an immediate adjustment, though in the long run the tendency is more evident.

(ii) "Productivity" is liable to be used in a double sense, viz an addition to the quantity of goods, and an increase in their value An addition to supply may well bring about a fall in value. Since workers are, in general, remunerated out of the selling price of their products, an increase in their output does not necessarily imply that the employers' wage-paying capacity increases in the same degree

In so far as productivity is taken to denote a measure of service to the community, market value may be a poor criterion. The productivity, in this sense, of an agricultural worker may be greater than that of some better-paid artisans. A woman may be more productive in a textile factory than in a football pool office, irrespective of whether her wages are higher or lower. It would be a difficult matter to compare the productivity of a civil servant who is concerned with issuing and checking forms and of a business official whose task it is to fill them up.

The exponents of the marginal productivity theory of wages, however, do not claim that it offers a complete explanation of wages determination. In Marshall's words: "The doctrine that the earnings of a worker tend to be equal to the net product has by itself no real meaning, since, in order to estimate net product, we have to take for granted all the expenses of production of the commodity on which he works, other than his own wages." As already shown, it is at the margin that the forces governing value can best be studied. No more is claimed than that the marginal productivity theory "throws into clear light the action of one of the causes that govern wages."

Though the doctrine is admittedly incomplete, it comes nearer to reality than its predecessors and clarifies a number of problems which they left unresolved It takes a broader view of wages and of the function of labour and is uninhibited by conceptions of a fixed fund or of pressure of population which so distorted the earlier theories.

Relative Wages

Variations in wages from one trade to another are only partially explained by the general theory The workers in different trades may form *non-competing groups*, between which there is imperfect mobility, and in consequence there may be a wide disparity in earnings.

In so far as wages vary from person to person or from group to group because of differences in productivity, there is no need for modification in the general theory. There are, however, several particular causes of variations.

(i) *Conditions of supply.* Where labour supplies are comparatively plentiful (e.g. in the semi-skilled trades), wages tend to be low.

(ii) *Ignorance and inertia.* For either of these reasons labour may fail to move from badly to better-paid employment.

(iii) *Cost of learning a trade.* The initial costs of training serve to limit entrance to certain occupations, and to keep wages in them disproportionately high.

(iv) *Attractiveness of occupation* Trades that involve disagreeable or dangerous work may pay higher wages as a form of compensation, though this is far from being a general rule.

(v) *Bargaining strength* In those trades in which trade unionism is strong the rate of payment is usually higher than in those occupations in which the workers' bargaining power is relatively weak.

(vi) *Protection from foreign competition.* Workers in "sheltered" industries, such as the transport and public services, are not so subject to foreign competition as workers in such industries as textiles and engineering.

(vii) *Custom and tradition* The remuneration in certain occupations is influenced partly by custom and tradition, though with the greater mobility of labour, the growth of trade unionism, and the extension of wages legislation, these factors have lost much of their force. In recent years, largely as a result of mechanization, the position of the less skilled workers in relation to that of the more skilled has, on the whole, greatly improved, and the "wage differential" has correspondingly narrowed.

Local Variations in Wages

The market for labour being far from perfect, the rates of remuneration are apt to vary, especially in certain trades, from one region to another. The main reasons for this local variation are—

(i) The comparative immobility of labour, which permits of an amplitude or even redundancy of workers in one part of the country while there are shortages in another.

(ii) Variations in the cost of living, which naturally influence the supply price of labour.

(iii) Variations in wage-paying capacity. Where firms are close together the same scale of wage rates tends to operate, irrespective of the efficiency of the particular organizations, but where they are scattered over the country competition is less effective and differences in remuneration are more possible.

Women's Wages

The question of women's wages as compared with men's is really part of the larger problem of relative wages, but, in view of some special problems involved, it may be separately examined.

Among the reasons commonly given for the lower wages of women workers are—

(i) *Smaller physical needs* The actual requirements in the way of foodstuffs may be less on the average for women than for men, but the standard of living ought not to be expressed only in terms of food In assessing this standard, provision should be made for the greater expenditure by women on clothing and other commodities.

(ii) *Fewer dependants.* Men workers, in general, have more dependants to support, and therefore tend to conceive of a higher minimum than women workers. But, as previously stated, it is productivity rather than needs, whether of oneself or of one's dependants, by which wages in the existing economic system tend to be governed.

(iii) *Inferior bargaining strength.* Women are, as a rule, more difficult to organize in trade unions than men are, and their bargaining power is thus on the average much weaker. Where the women are well organized, such as in the textile trades, the disparity in wages is not so pronounced, particularly where the men's unions take the view that low rates for women workers are liable indirectly to have an adverse influence on wages in general.

(iv) *"Meantime" character of occupation.* The reason for the weaker organization of women workers lies partly in the short view that many of them take of their industrial employment. Marriage ordinarily means for women the cessation of such employment, whereas for men it results, if anything, in greater application than before

(v) *Inferior training.* The "meantime" nature of most women's employment naturally affects the extent to which, either of their own volition or through the action of their parents, they enter upon a course of specialized training, and thus qualify for the better-paid work.

(vi) *Greater immobility.* Women are, on the average, less easily induced than men to move to another part of the country or, where opportunity offers, to change their employment. Hence, women's wage rates may show a wide disparity from one locality or trade to another without causing a heavy flow of labour to the better-paid employment.

(vii) *Subsidy to earnings.* Many women in industry are subsidized from home in one form or another, and their insistence on the best possible rates is accordingly weakened. While the competition of the "pocket-money" worker is apt to be exaggerated, it is by no means negligible in some of the more pleasant forms of occupation.

(viii) *Weaker physical strength* This factor, too, tends to be over-rated, especially in view of the marked improvement in recent times in women's physique. Some of the more arduous occupations, however, are not suitable for women, and this, together with a number of deliberately imposed restrictions, tends to limit the field of women's employment.

(ix) *Greater expenses of employment.* Partly because of the greater liability of women to sickness, and partly because of the heavier expense in which he is involved in complying with factory regulations governing women's working conditions, the employer may seek to justify a lower rate of remuneration. On the other hand, expenditure on "welfare" facilities may indirectly add to the efficiency of the workers, and the fact that many employers incur expenditure of this kind in excess of the legal requirements points to the limitations of the above argument.

(x) *Lower productivity and smaller demand.* Taking all these factors into account, it may be concluded that the worth of women workers to the employer tends as a rule to be less than that of men workers, and the demand for women is smaller in consequence. There are admittedly certain trades in which women are no less efficient, and may in fact be more efficient, than men, but, over industry as a whole, the demand for women workers is definitely smaller, and their remuneration tends to be lower in consequence.

Section 3. Labour and Wages Problems

Unemployment

A disquieting feature of modern industry is the liability to dislocation and unemployment Whereas in the nineteenth century the average rate of unemployment was about 5 per cent and seldom reached 10 per cent, the proportion in the first part of the twentieth century was much higher, reaching 20 per cent in the "Great Depression" of 1929–1931. Even under conditions of "full employment,"[1] there may be large numbers who, for reasons of lack of special skill, personal disability, etc., cannot find work.

The problem is intimately bound up with that of trade fluctuations, which are considered in Chapter XVII. For the present it will be sufficient to note some of the more general aspects

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[1] "Full employment" was defined by Lord Beveridge as a condition in which there are "always more vacant jobs than unemployed men, not slightly fewer jobs It means that the jobs are at fair wages, of such a kind, and so located, that the unemployed can reasonably be expected to take them, it means that the normal lag between one job and finding another will be very short" (*Full Employment in a Free Society*, 1944) See Chapter XXIII.

When production was simple and division of labour comparatively undeveloped, the amount of unemployment was inconsiderable. Even when the volume and scale of production increased, the market was more or less known and guaranteed, and the risks both to the employers and to the workers were relatively small. Much of the unemployment was *seasonal* or *transitional* rather than *structural* In the course of time, however, production became increasingly specialized and involved and much of it had to be undertaken in anticipation of a perhaps precarious demand rather than for a known and certain market.

Against the economies resulting from large-scale and continuous production has to be set the possibility, under competitive conditions, of an inadequate co-ordination among the different firms which, in their efforts to expand their own trade, may find that collectively they turn out a greater volume of goods than can profitably be disposed of. "Over-production" may be followed by a period of restriction, which causes unemployment not only in the industries immediately concerned, but also in the ancillary and other trades serving them.

"Unemployment breeds unemployment," particularly where the trouble begins in an industry which is vital to the existence of others. Thus industrial breakdown may have a dual repercussion. It may disrupt production through a chain of dependent trades. It may curtail earnings and other incomes, with the result that spending power is reduced and unemployment is thereby caused in other directions.

Machinery and Unemployment

The introduction of labour-saving machinery is clearly major factor in employment, but the adverse effects re liable to be exaggerated

(*a*) The introduction of machinery is frequently followed y a reduction in the price of the product. Unless he demand for the commodity is very inelastic, the creased output called for by the new conditions may nable some, if not the whole, of the displaced workers o be re-employed.

(*b*) New employment is created in the making of he machinery and in the subsidiary industries that rise (though the labour taken on, of course, is rarely the ame as that dismissed in the other trades).

(*c*) Even if the public do not require sufficient of the ew machine-made goods to retain the original number f men in making them, the cheapening in price may elease demands for other goods calling for greater mployment in their production

(*d*) It might be maintained that when everybody had ll that was required, and no reduction in price induced urther purchases, the problem of unemployment would e insoluble On the contrary, under such conditions eople would work fewer hours In effect they would buy ore leisure, and the supply of redundant labour would e reduced in consequence.

(*e*) Another modifying factor is the long period often lapsing between the invention and the actual introduction f a machine, especially where a large capital has been vested in the earlier equipment The "time lag" acts as brake on too speedy displacement, though it must be dmitted that, under the stress of modern competition, he period between the invention and the utilization of he machine shows a tendency to diminish.

Rationalization. The relationship between rationaliza-ion and unemployment is fairly similar. The object of ationalization is usually to reduce costs and increase sales, and, though there is liable to be dislocation and unemployment during the period of transition, it is hoped that there will be more stability and, though this is not so certain, greater employment under a more rational system of industry.

The liability of new processes and of new methods of organization to cause unemployment is no reason why they should necessarily be opposed, for it is in the general interests that arduous and unpleasant labour should be lightened and eliminated wherever possible. The fault lies not in the labour-saving devices themselves, but in the ill-balanced economic machine, which so far has not succeeded in spreading the benefits of such improvements over the people as a whole.

In recent years a noticeable change has come about in the attitude to the introduction of new machinery and, more significantly, to the redeployment of labour within industrial establishments and between one trade and another. It is increasingly recognized that without such measures the desired improvement in national productivity cannot be attained

Trade Unionism

The trade union movement is mainly the product of the Industrial Revolution and of the factory system. Though workmen's combinations were by no means unknown, even as far back as the sixteenth century, it was not until workers became congregated in large numbers in factories and towns that organizations with the expressed object of safeguarding and advancing the workers' interests seriously developed.

A trade union was defined by the Webbs as "a continuous association of wage-earners for the purpose of maintaining and improving the conditions of their working lives " The element of continuity is important, as early labour organizations were usually called into existence only in times of dispute, and dissolved when they had served the immediate purpose Continuity of association was found to be essential, not only for efficiency of administration and for preparedness in the event of dispute, but also as a means of holding in check those employers who, in the absence of a permanent organization of labour, might on occasion unfairly exploit their power.

Early trade unions were confined to male skilled workers, but, following the "New Unionism" movement towards the end of last century, women and unskilled workers were admitted to membership of many unions. This change in attitude was largely attributable to the realization that it was in the common interest that the several types of workers in an industry should come within a single organization It became increasingly patent, as mechanization proceeded, that workers with comparatively little training could often, with the aid of semi-automatic equipment, effectively compete with skilled craftsmen There are still, however, several old-established unions in which the former prejudices and restrictions still continue, and which persist, so far as they are able, in maintaining the wage differential between the various grades of labour

Trade Union Structure

The different forms of trade unionism do not lend themselves easily to classification, for most unions have developed on more or less independent lines to cope with the peculiar conditions of individual industries or occupations.

(1) **Union by Craft.** The early organizations of skilled workers consisted mainly of men engaged in performing similar operations, irrespective perhaps of the main industry in which they were employed. Even now engineers in the railway, motor, iron and steel industries may

belong to a single union, or group of unions, that cut "horizontally" across the ordinary industrial boundaries. Or, as in the case of the cotton spinners or weavers, the craft union may be confined to a single industry, but still be sectional in character in that it embraces only a part of the total labour force.

There are some unions organized on the basis of the material used—such as the woodworkers' union, comprising joiners, carpenters, and cabinet-makers—but for practical purposes they may be classed as craft unions

(ii) **Union by Industry.** Trade unionism in the nineteenth century was in the main on a craft basis, but subsequently, important changes took place in favour of the "industrial" form of organization. The new type of union aimed at bringing together the whole of the workers within an industry irrespective of their skill or grading. It was considered that this "vertical" form of organization would be more effective than the "horizontal" craft union in negotiating with and wresting concessions from the employers. Thus, for example, the National Union of Railwaymen aims at incorporating railway workers of every class, though so far the locomotive engineers and the railway clerks have retained their own unions. (Trade unionism is as necessary under nationalized as under private industry.) Similar attempts have been made in the mining and building trades, which are organized largely on an industrial but not as yet on a national basis. The movement for "industrial unionism" has not had all the success that was expected, and the craft union is still firmly entrenched in many trades.

It is significant that the number of trade unions has shown a marked shrinkage in recent years, not because of a fall in membership (apart from some natural shrinkage in times of depression), but because of the spread of amalgamation Owing to this concentration, about nine-tenths of the total membership of the movement are found to be in about one-sixteenth of the number of unions.

(iii) **Union of General Labour.** Unions of this kind have grown up in recent years without regard to skill or industrial attachment. The largest of these is the Transport and General Workers' Union which draws its members from a wide field of occupations.

Trade Union Functions

All unions have the common and basic function of representing their members in negotiations with the employers. Beyond this the activities of the unions show a certain variation.

(i) **Collective Bargaining.** Collective negotiation with employers, who usually have their own associations, is recognized to be the most important function of trade unions. It is only in recent times that employers in general have been induced to recognize the unions as the accredited agencies of negotiation, and now in most of the important industries collective bargaining machinery consisting of representatives of the respective organizations, exists for regulating wages rates and working conditions. Where the several unions in a particular industry have not amalgamated, some form of federation or understanding is an essential condition to negotiation on a large scale.

The negotiating machinery has, on the whole, been very successful, and has secured concessions for the workers with less resort to the strike weapon than in industries where the system is not so advanced The publicity, however, given to strikes and lock-outs is apt to give a false impression of their prevalence. In average years more than 95 per cent of changes in wages rates is effected by peaceful negotiations.

The structure of a trade union is apt to be impaired, and the fulfilment of its main function of collective bargaining incomplete, if it is unable to include such a large proportion of the workers as to exercise an effective control over labour supply. There are some functions that can be carried out if only a proportion of the workers are covered by the union, but for successful bargaining with the employers the officials must have the support of the great majority, if not the whole, of the labour force in the trade. The movement for a "closed shop" has gained much support in labour circles, though it is naturally resisted in other quarters as well as among some sections of the workers themselves.

(ii) **Mutual Insurance and Aid.** From the funds raised by members' subscriptions, various benefits are provided—

(*a*) Dispute benefit. This service is closely bound up with the primary function of collective bargaining, and might be equally included under that head;

(*b*) Trade benefits, such as unemployment pay;

(*c*) Friendly benefits, such as funeral, sick, and superannuation pay

The continued provision of friendly benefits is opposed in some quarters on the ground that it tends to make a union unduly conservative and over-cautious But these benefits are a useful means of attracting workers who might not otherwise join the union. It has been held that the social insurance services of the State render this function of trade unions out of date and unnecessary. A strong case can be made out, however, for the continuance of trade union benefits to supplement those provided by the State, since the national insurance payments do no more than provide the bare means of subsistence.

(iii) **Political Action.** Long before the trade unions participated in party politics, they had taken action, though indirectly, in initiating or influencing legislation for improving the conditions of the working classes. In the nineteenth century there were many instances of organized labour using its then limited powers to promote or to oppose parliamentary bills. In the present century political action became more direct, and with the rapid rise of the Labour Party the representation of trade union interests came very much to the front

Industrial Disputes

The extent of industrial stoppages in recent years is shown in the accompanying table

INDUSTRIAL STOPPAGES[1]

	Number of Stoppages	Workers Involved 000	Total Working Days Lost 000
1938	875	274	1,332
1952	1,714	415	1,797
1953	1,746	1,370	2,173
1954	1,989	448	2,480
1955	2,419	659	3,788
1956	2,648	507	2,051
1957	2,859	1,356	8,399
1958	2,629	523	3,474

[1] Ministry of Labour

The main factors in disputes have been—

(i) **Wages.** Nearly three-quarters of industrial disputes are attributed to differences over wages In times of rising prices and improving trade, the initiative comes from the workers, who claim to participate in the greater profits. In times of falling prices and declining trade, the first move is usually with the employers

(ii) **Working Hours.** A common cause of dispute is in the number and distribution of working hours After a certain standard of income has been reached, workers are apt to lay relatively less stress on further wage advances and more on hours and, in many cases, a guaranteed week.

(iii) **Working Conditions.** These are sometimes linked with working hours as a cause of dispute, but have figured somewhat less in recent years owing to the extension of the Factory Acts as well as to voluntary provisions by enlightened employers

(iv) **Trade Union Status and Recognition.** The right to negotiate through trade unions used to be a common cause of dispute in the past, but, with almost universal recognition by the employers of the legitimate function of the unions, this element on disputes has greatly diminished

Settlement of Disputes

The methods of dealing with labour disputes vary considerably, depending largely on the conditions in particular industries and services Most questions at issue are settled by direct negotiation between the employers' and workers' organizations without need for public intervention of any kind An increasing number of industries, including those in public ownership, have their own tribunals, and machinery for joint consultation is becoming more widespread In the last resort, however, some form of public action may be imperative, and provision for this has been embodied in legislation

(i) **Conciliation Boards.** These Boards, which may be permanent or temporary in nature, consist of representatives of employers and employed, and possibly of outside members in addition. Disputes are referred to the Boards and, in the event of no agreement being reached, there may be arrangements for appointing one or more arbitrators to give their award. As, however, the system works on a voluntary basis, the parties are not bound to accept such a decision.

(ii) **Arbitration.**

(*a*) *Voluntary.* The Conciliation Act of 1896 gave the Government the power to intervene in a dispute, to bring the parties together, and, if invited, to appoint arbitrators. But a decision given by an arbitrator is usually less satisfactory than one arrived at by direct discussion, mutual concession, and final agreement. It is difficult to find an arbitrator who is perfectly impartial, especially if he is connected with the trade concerned. And if he is an "outsider" much time may be lost in the explanation of technical points.

In 1940 the National Arbitration Tribunal was established by the Ministry of Labour and National Service for dealing with disputes that could not otherwise be settled This Tribunal consists of high-ranking representatives of trade unions and employers' organizations, together with a number of independent members Its functions are more fully noted below.

(*b*) *Compulsory*. Though compulsory arbitration involving legal enforcement of the decision has been practised in some of the Dominions and elsewhere, opinion in this country has in general been opposed to it, except in times of national emergency

(iii) **Industrial Council.** In 1911 a Council was established, composed of twenty-six members, equally representative of employers and labour, and a chairman. It was to consider and inquire into trade disputes, and be regarded as supplementary to the machinery of the Conciliation Act of 1896. Provision was made for investigation, conciliation, or arbitration, as the occasion required. The Industrial Council could only make recommendations, it had no compulsory powers. The Council did not have a marked measure of success and was, in effect, superseded by subsequent schemes.

(iv) **Joint Industrial Councils.** A Government Committee, which was appointed in 1916, recommended "the establishment for each industry of an organization representative of employers and workpeople to have as its object the regular consideration of matters affecting the progress and well-being of the trade from the point of view of all those engaged in it, so far as it is consistent with the general interest of the community." For each industry there were to be permanent national, district, and workshop councils, all meeting regularly. These councils were to be concerned not only with wages and hours, but also with working conditions throughout all branches of the industry. Again the basis was voluntary. Within a short time Councils were established in over sixty industries as well as in the Civil Service. Subsequently, however, many of these bodies were dissolved or became moribund. In the industries in which they still continue they perform a useful though limited service.

(v) **Industrial Courts Act, 1919.** Under Part I of this Act, a standing Industrial Court was appointed by the Ministry of Labour, consisting of representatives of employers and workers, together with a number of independent persons. With the consent of both parties, any trade dispute may be referred to this Court, which makes full inquiry, and may take evidence The chairman, who is chosen from the independent members, serves as umpire, but his decision cannot be legally enforced.

Under Part II of the Act, the Ministry of Labour was authorized to set up a Court of Inquiry for any industrial dispute and to make public the evidence and findings. The publicity given to the factors in dispute has been the means of expediting a number of settlements.

(vi) **Industrial Disputes Tribunal.** In 1951 the Industrial Disputes Tribunal was constituted by the Ministry of Labour and National Service for the purpose of determining issues which could not otherwise be settled This procedure did not come into operation automatically, but had to be requested by one of the parties In 1958 it was considered no longer effective and was abolished

CHAPTER X

INTEREST AND PROFITS

Section 1 *Interest*

Analysis of Gross Interest

THE price paid for the use of capital is known as interest. In so far as it determines the amount of capital employed in production, and the form and direction of investment, it affects the volume of employment of labour and the welfare of the community as a whole.

Interest should not be identified with profits, which in theory represent the return to the entrepreneur for his services as distinct from the payment for the use of capital alone In practice, however, there is often a large element of profits in interest as popularly understood. Accordingly it is necessary to make a distinction between *Net* and *Gross Interest*.

Net Interest is the payment made for the use of capital, without any allowance for risk or any other factor. It is almost impossible to find actual instances of this pure return; for practical purposes, however, the interest on Government stocks and similar gilt-edged securities may be taken as a near approximation.

Gross Interest is the inclusive return to an investment of capital, and normally comprises—

(*a*) Net interest;
(*b*) Reward for risk;
(*c*) Payment for services, book-keeping, etc.[1]

The Nature of Interest

Early writers regarded interest as unwarranted. From the days of Aristotle to the Middle Ages philosophers held that money was "barren"; that it could not breed money Following the ban of the Church, usury came to be prohibited by law In the course of time, however, the regulations proved unduly restrictive, and many subterfuges were adopted to circumvent them. People were continually requiring money and offering a payment for its use. With the Industrial Revolution the need for capital was intensified, and Parliament, realizing that the usury laws were an anachronism, formally repealed them in 1854.

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[1] There may be, in addition, an element of "quasi-rent", see p 177

The objection to interest in the past can readily be understood. Capital was not used in the same way and to the same extent as now. Money borrowed was dissipated as often as not. There was little to be seen as a result of the consumption, and nothing apparently to justify the payment of interest on the loan.

The Productivity Theory

It used to be contended by early economists that, in the same way as land produces crops, so capital produces interest. The early form of the theory attributed to capital a productive capacity *per se*. Where a loan took the form of live-stock, the specific productivity was very obvious. But with the modern form of capital the self-generating productivity, as it were, was not so easy to prove For instance, a man working by hand turns out so many units; with the aid of a tool he doubles his output. Is the extra output due to the tool or the labour? Clearly it is not due to the tool alone, which is useless without labour, or to the man's labour alone, but to the combination of the two factors But whoever gets the fruit of the employment of capital, there is no question that by its use production is increased.

The productivity theory contains much truth, but it does not account for the payment of interest on that capital which, for different reasons, may not yield any product at all. It tries to explain interest from the side of demand only. Other deficiencies can be ascertained by comparing this theory with other attempts, previously noted, to explain value from one side only.

The Abstinence Theory

According to the abstinence theory interest is said to be the reward of abstaining from the immediate consumption of wealth As the word "abstinence" might be taken to imply some sacrifice, or even pain, the term "waiting" is sometimes preferred Applying the marginal method to this theory, some recent economists attempt to show by steps similar to those employed above that, on the supply side, the estimate of the marginal investor (or that placed on the marginal investment) tends to equal the amount of interest paid.

This view of interest is true up to a point, but it cannot be considered complete. Though productivity is not the only, it is a very important, factor in the explanation of interest, and the abstinence theory gives to it insufficient attention.

The "Agio" Theory

In the "agio"[1] theory an attempt is made to explain what it is that determines the rate conducive to the supply of the marginal investment The theory is usually associated with Prof von Bohm-Bawerk, who, together with other members of the Austrian school, made considerable use of psychology in explaining economic phenomena.

The fundamental reason for interest, it is maintained, lies in the fact that *a man prefers present to future satis-*

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[1] Originally denoting a percentage paid on the exchange of currencies, "agio" came to mean the premium or discount on bills of exchange

factions. If he is asked to choose between an immediate receipt of £100, and the same sum a year hence, he will prefer it in the present, quite apart from any consideration of risk (which is rewarded by a return to enterprise as distinct from payment for capital). If he has to choose between £100 now and £102 in twelve months time he may still prefer to have the money without delay. But if the choice is between £100 now and £103 later, he may just be persuaded to forgo payment in the present. The sum of £3 may be said to represent the loss in satisfaction that he experiences by postponing for one year the consumption of £100 worth of goods. It is this surplus of present over future satisfactions that is said to explain the payment of interest. Hence the expression, "*Interest is the price of time*"

The "agio" theory, while doubtless containing an element of truth, tends to regard interest too much from the side of supply, and to give insufficient weight to the productivity and services of capital which are at the basis of demand.

The Determination of the Rate of Interest

In the open competitive market the rate of interest[1] is determined in the same way as other values, borrowers in this case comprising the demand and lenders the supply. The demand comes mainly from those who wish to employ the capital for productive purposes, but even where it is not so used, the loan confers a service and has to be paid for.

The employment of capital is subject to the law of diminishing utility. A manufacturer may find, for example, that the tenth unit of £1,000 yields a smaller specific product than the fifth £1,000. The greater the

[1] The effective rate of interest in recent years has been influenced by Government policy. See Chapter XIV, Sect 3 and Chapter XXII

supply of capital, the lower will the marginal productivity become. From the side of demand, the value of the use of capital (i.e. the interest) tends to equal the marginal utility as measured by the value of the product.

The supply of capital, as previously shown, depends upon the power and the will to save. The rate of interest naturally has an influence on the accumulation of capital, though a certain amount of wealth would be conserved in any case[1] As a general rule, however, it may be stated that, from the side of supply, the rate of interest tends to equal the reward to the marginal investor, or more particularly, the estimate placed upon the marginal investment, as determined by the relative valuation of present and future goods.

The rate of interest tends ultimately to the point at which the marginal productivity of the capital and the estimate placed upon the marginal investment, both as measured in money, are equal.

The Tendency for the Rate of Interest to Fall

There is a certain tendency, as society advances, for the rate of interest to decline, quite apart from authoritarian measures directed to that end. Briefly the main reasons have been—

(i) The considerable expansion in productive capacity, which, despite the growth of consumption, normally permits of a larger surplus for capital purposes.

(ii) The greater ability of the people in general to save consequent upon the general improvement in incomes (apart, of course, from periods of abnormally high taxation). Once the elementary necessaries of life are provided for, an increase in income permits of a more than proportionate increase in the amount of possible saving.

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[1] Up to a point a diminution in the rate of interest may have the effect of stimulating greater savings on the part of those people who are aiming at a fixed income from their accumulations, while, for the same reason, an increase in the rate of interest may cause these people to lessen their capital accumulations Life assurance schemes are similarly affected

(iii) The increase in the ability and the desire to save, and also in the opportunity and scope of investment.

(iv) The existence of a large number of people who save with little or no regard to the rate of interest. This supply of capital, more or less independent of the price offered, naturally serves to strengthen the position of the borrowers in relation to the lenders as a whole, and the rate tends to be lower than it would be if every lender were out to get the best terms.

Theoretically, it has been maintained that the rate of interest may continue to decline until it disappears, but such a situation is extremely unlikely ever to arise. The surplus of production over consumption can hardly become so large in relation to demand that the marginal productivity of the capital employed sinks to zero.

Section 2. Profits

Analysis of Gross Profits

In the early stages of economic analysis the entrepreneur and the capitalist were regarded as identical, and therefore no real distinction was drawn between interest and profits. Later it was recognized that, while one man might serve as both capitalist and entrepreneur, he was in a sense performing a double function, namely, supplying the use of capital and engaging in economic enterprise. It is seldom that a man acts as entrepreneur without providing a certain amount of capital, and that a man invests capital without at the same time incurring some degree of risk, and consequently it is unrealistic to draw a rigid distinction between the two forms of service and income. Nevertheless, it helps towards a better understanding of the distribution of income if the two functions and their rewards are separately considered.

In an analysis of the ordinary profits of a business, returns to some or all of the following elements may be found—

(i) **Net Interest.** Gross profits ordinarily include some return on capital, though the more accurately a statement of profit is prepared, the less is the likelihood of confusion. A small producer, working with his own capital, may not trouble to separate the different items in the gross return, but a large business finds it essential to draw the distinctions, and compute the net returns accordingly. The ratio of pure interest in the dividends from investments varies considerably. The yield from debenture holdings contains a higher percentage of net interest than does the dividend paid on ordinary shares. The proportion of true profit in the gross yield increases as one passes from bonds and debentures at the one extreme to deferred shares at the other.[1]

(ii) **Payment for Organization or Management.** This is a reward for part of the duties often performed by the entrepreneur. In a sense, it resembles the remuneration he would receive if he acted as a paid manager, and is thus akin to a salary or fee (though allowance must be made for the advantages of the employer's position compared with that of a paid manager). The earnings of the entrepreneur cannot permanently fall below the "wages of management." If they did he might find it preferable to seek salaried employment.

(iii) **Compensation for Risk.** Since production has to be carried out usually in anticipation of demand, there is always a certain amount of risk involved. Long before the final product is paid for by the customer, money has been paid out for labour, materials and borrowed capital. The most skilled of entrepreneurs may have their estimates of demand upset by factors that cannot be foreseen, such as changes in fashion, vagaries of weather, political disturbances, etc. Up to a point it is possible by means of insurance to spread industrial risks and thereby reduce individual liability.[1]

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[1] See pp. 231–2.

(iv) **Monopoly Gains.** A firm in a position of monopoly may derive a profit considerably in excess of the rate prevailing under competitive conditions Even if it does not possess a complete control over the supply of a commodity, it may possess certain advantages that result in a greater gain than that accruing to less fortunate rivals. Such advantages may be due to superior management, or better situation in regard to the market, or to several other circumstances not shared by the marginal firm, whose reward is only just sufficient to permit of existence.

(v) **Chance Gains.** Profits sometimes arise from the conjuncture of circumstances which cannot be predicted, and which takes place independently of any effort or foresight of those benefiting. While the element of chance in profits is liable to be exaggerated, it remains an important factor.

(vi) **Normal Profit.** The net return to the marginal firm may be regarded as the normal profit It constitutes an element in the gross profits of all firms, though it may be overshadowed by other items.

The Marginal Theory of Profits

Under competitive conditions a number of firms may be engaged in producing a given type of article that sells for the same price in all markets irrespective of the source from which it comes. The price is fixed for, and not by, the individual firms, and just covers the costs of the marginal firm, in which the minimum reward for enterprise is allowed for. The supra-marginal firms incur lower costs, but as they can sell the whole of their output at the prevailing market price, they are enabled to make a larger profit commensurate with the advantage they enjoy. In the long run they may extend their scale of production and lower their prices in order to capture their rivals' share of the market, and the nearer they approach to a complete control of supply, the closer may be the resemblance between a part of their earnings and a monopoly revenue. The differential gain, whether it is regarded as a form of monopoly profit or not, is in some ways similar to an economic rent, as will be shown in the following chapter.

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[1] See pp. 232–4

The basic element in profits seems, then, to be the normal rate which the firm on the margin must receive over a period or cease producing. It is difficult to estimate what this is to be, as it depends on so many varying factors. The nature of the industry is one, the age of the firm is another. It cannot be said that profits tend to an equality any more than wages, but there appears to be in every trade a certain minimum profit below which, taking everything into consideration, a firm will not carry on for long.

This minimum, however, cannot always be reduced to a single type of reward or expressed as a simple amount, for even when the measurable items for net interest, wages of management, and reward for risk have been deducted, there frequently remains a dual element which does not admit of simple analysis.

Other Theories of Profits

The above theory of profits is admittedly incomplete, and there is still considerable difference of opinion among economists as to the real nature of this form of income, if indeed it can be reduced to a single form

Profits the Result of Change

A more recent theory maintains that profits are the result of change, which is always going on in the prevailing system. If we lived in a stationary and perfectly competitive system, pure profit would tend to disappear. Prices of all services would be fixed in advance by the value of their marginal products. The rewards of wages, interest and rent would be sufficient inducement to keep production going. In practice, of course, the system is far from being stationary—population is increasing, wants become more numerous and diverse, new technical processes are discovered, and so on. It is in the process of adjustment from one stage to another that profits emerge. They are held to be the reward to the entrepreneur for his services in bringing about a new equilibrium.

A modification of this theory is the distinction drawn between foreseen and unforeseen change. Where changes are predictable, necessary measures can be taken and thus there can be no profits that depend essentially on uncertainty for their emergence. It is only where change is unforeseen, and where there is ignorance of the future that true profits arise. In short, to quote Professor Knight, profits come from "the divergence of actual conditions from those which have been expected and on the basis of which business arrangements have been made."

The Marxian Theory

Karl Marx and his present-day followers take an altogether different view of profits The total income of a community is said to be made up of two constituents only—wages and profits. In the capitalist system labour does not get the whole reward measured by its productivity It tends to receive only that amount which is necessary to induce a continuous supply of labour-power, but which is in reality much less than the value of labour's product. (The relationship of this doctrine to the classical cost of production theory will be observed.) The difference between the output and reward (i.e. "surplus product") forms the basis of the "surplus value" or profits taken by the capitalist employers. The final allocation of this surplus among capitalists is determined by their respective bargaining powers.

The Tendency for the Rate of Profits to Fall

The close relationship between interest and profits is illustrated by the apparent tendencies for their rates to decline over a lengthy period The trend of the rate of interest has already been considered That of the rate of profits is subject to similar influences. As business men acquire greater knowledge and experience, and can take increasing advantage of new methods, both technological and organizational, the chances of very large profits, though still appreciable under the prevailing system, are liable to be curtailed.

This tendency, however, is by no means universal, for the rate of profit in certain industries shows no sign of declining and is even tending to increase. In the newer industries, especially, there are special opportunities for skilled entrepreneurs, and the average rate of gain is comparatively high. Also, in those industries in which monopoly has replaced competition the usual rate of profit is hardly in accord with the supposed tendency to decline Indeed, in so far as profit resembles a form of economic rent, which is akin to monopoly income, it is more likely to increase than to diminish. The applications of the rent doctrine to profits, as well as to interest and wages, will be considered in the following chapter.

CHAPTER XI

RENT ELEMENTS IN INCOME

Section 1. *The Theory of Rent*

The Meaning of Economic Rent

RENT, in the strict sense, denotes the payment for the use of the natural factor of production.

As defined by Ricardo over a century ago, rent was said to be "that portion of the produce of the earth which is paid to the landlord for the use of the original and indestructible powers of the soil." As later re-defined by Marshall, it was stated to be "the income derived from the ownership of land and other free gifts of nature."

Economic rent and ordinary rental should be carefully distinguished. The rental of buildings or agricultural land usually includes not only a certain amount of pure rent, but also items in respect of interest, profits, depreciation allowances, etc. True rent may prove to be only a small proportion of the total hire value In the long run, however, capital improvements to land may, as noted in Chapter III, become inseparable from the land itself, and the above distinction for practical purposes tends to disappear.

The Ricardian Theory of Rent

Ricardo, in common with other members of the Classical School, held that value was determined by cost of production, and attempted to apply this conception to the rewards of the various agents of production. The subsistence wage was held, in effect, to be the cost of production of labour. Interest, being the inducement to people to abstain from present consumption, was regarded as the cost of production of capital. But when the notion came to be applied to the return to land, many difficulties arose. Land is not "produced" in the ordinary sense of the term, and its amount is constant whatever price is offered Ricardo, therefore, sought another explanation of the nature and determination of rent.

The earliest and crudest form of the theory may first be outlined. Imagine a limited area of virgin land to which come a number of settlers. Presumably the newcomers appropriate the most productive land, which yields, say, 100 bushels of wheat for a given amount of land and labour. Suppose all the best land has been appropriated, and some more settlers arrive. The latter are at liberty to acquire free the second-best land, which for the same area and labour yields 90 bushels of wheat. Alternatively, they may approach the first-comers and ask them on what terms the best land can be rented. If no capital has been invested in the superior land, the owners will tend to demand a rent up to the equivalent of 10 bushels (i.e. the difference in the productivity of the two lands). At that figure it is a matter of indifference to the new settlers whether they cultivate the second-best land paying no rent, or take over the best land and pay a rent of 10 bushels. If the owners of the best land ask for a lower rent than this, competition among the new arrivals will force the price up; if a higher figure is named, it will be more advantageous for the newcomers to cultivate the inferior land rent-free.

Suppose that the first- and second-class land is appropriated when further settlers arrive. These may be content with the third-class land, which yields 80 bushels for the given area and labour, or pay the owners of the second-class land a rent of 10 bushels, or the owners of the first-class land a rent of 20 bushels. Thus, increasing pressure on the limited amount of land causes the rent to rise without any effort on the part of the owner.

Importance of Situation

This purely imaginary illustration is brought a little nearer to actual conditions if with the fertility of the land one considers its situation. Thus in the above instance the settlers might appropriate the land nearest to hand if they were ignorant of where the most fertile land was to be found. But even if this were known, it might not pay to cultivate it because of inconvenient location or expense of transport. If the most fertile land bore an advantage of 10 bushels over the land immediately available, but necessitated an expenditure equivalent to 20 bushels in transporting the crop, the *net product* of the less fertile land would be greater than that of the more fertile land, and would yield consequently a higher rent

In thickly populated districts, and especially in industrial and commercial centres, rent of situation assumes a far greater importance than rent of fertility.

Diminishing Returns and Rent

It was shown in a previous chapter that, in the cultivation of land, one tends after a point to experience a diminishing return in the amount (not necessarily in the value) of the product. The reason why a plot of land is not cultivated as intensively as possible may be that the additional return is less than the extra cost of getting it. Thus, equal applications to a plot of land may yield a varying return, the differences being comparable in a sense to the differential advantage of one piece of land over another.[1]

The Determination of Rent

The factors determining the rent of land may be briefly reviewed. Consider, first, lands of varying fertility. Land A may have an advantage of 10 bushels of corn for a given area over land B, which in turn has an advantage over land C of the same amount. The advantage of A over C is, therefore, 20 bushels There may be several other qualities of land, D, E, F, etc , all of which are profitable, in different degree, to cultivate. Which land serves as the basis for the determination of rent? The answer is *the land on the margin of cultivation*, i.e. the land which, at the price of the product ruling at the time, is just worth while cultivating To put it another way, the receipts from the product of the marginal land just cover the expenditure of the labour and capital applied; there is no surplus. As demonstrated in the chapters on value, it is the cost of the marginal product to which the price tends to approximate. Whether it is grown on the more productive or less productive land, the crop (assuming the quality is the same) is sold at the price which is necessary to cover the expenses of the marginal product. For lands of varying productivity there is said to be an *extensive margin*.

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[1] As already explained (p 33), the "doses" of capital and labour applied may be *successive* or *simultaneous*, and still be subject to diminishing returns

Similarly, with regard to different "doses" applied, the cultivator of one piece of land tends to invest capital and labour up to that point at which the return just covers the outlay. As was shown in the general discussion on value, he tends to produce up to the point at which the marginal costs equal price. For doses of capital and labour of varying productivity there is said to be an *intensive margin*.

The extra productivity of the superior over the marginal unit, whether the units be different grades of land or different doses of capital and labour, determines the amount of the rent.

If the price of the product rises, it becomes profitable to cultivate the land or employ the dose of capital and labour that previously yielded less than the outlay.

The margin is thus lowered, and the differential advantage or rent of the superior unit is raised.

If the price falls, it is no longer profitable to cultivate the land, or apply the dose of capital and labour, that was formerly at the margin. The level of the margin is therefore raised, and the differential advantage or rent of the superior unit is reduced.

As a general rule, a rise in the price of the product contributes to an increase in the rent, a fall in the price tends to bring about a reduction in the rent.

In reality the rent actually paid for land does not rise or fall automatically with the price of the product, since the payments are usually fixed by contract for a definite period, and any advantage or loss within that period accrues to the tenant But this does not disprove the variation in the true rent. If a long period is taken, to allow for contracts to terminate, the net payment (deducting interest, etc) will tend to approximate to the pure economic rent.

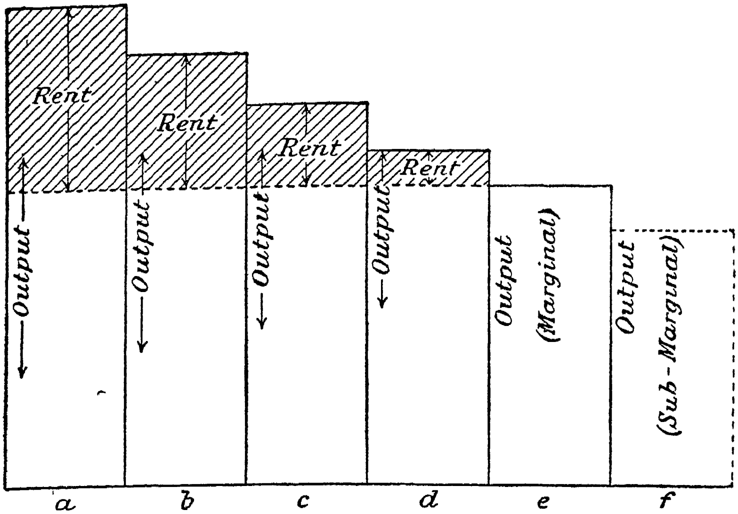
Diagrammatic Illustrations of Rent

The foregoing analysis may be illustrated in diagram form—

(1) Suppose that the rectangles (p 170) represent the output from equal doses applied to *different* pieces of land The most productive land yields an output measured by the whole of rectangle *a* (shaded as well as light portion). The second-best land yields a product measured by *b*, the third yields *c*, and so on. Remembering that the price of the product is fixed for the cultivator by the general conditions of supply and demand, suppose that the price of the product is just sufficient to induce the cultivation of that land which yields an output of *e* per given unit of capital and labour. Obviously it will not pay to cultivate the less productive land which yields only *f*. The land which

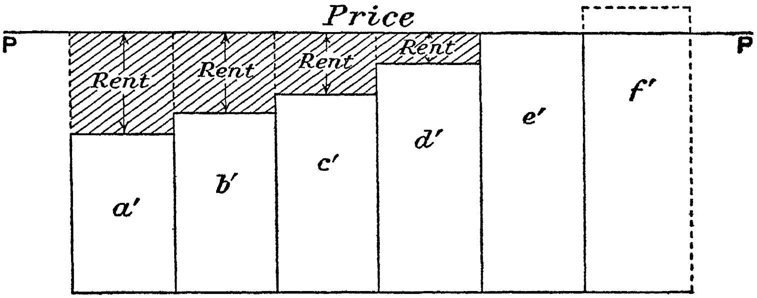
just yields sufficient to cover the outlay is on the margin of cultivation. The difference between the productivity of the superior and the marginal land is the rent, marked by the shaded portions in the diagram.

If the price of the product rises, then the sixth land may be brought into cultivation; *f* becomes the marginal output and the rents rise. If the price falls, the fourth land (*d*) becomes marginal and the rents fall.



(ii) Referring to the same diagram, suppose that the rectangles represent the output from equal doses applied to the *same* piece of land. The illustration is now similar to that of diminishing returns. One unit of capital and labour yields a product measured by *a* The second unit produces *b*. If two units are applied together, the yield is (*a* + *b*), i.e. less than 2*a* The fifth unit yields *e*, the sale of which just covers the cost Assuming that the cultivator knows exactly where to stop (though often it is impossible to know this precisely), no more than five units will be invested. The "surplus" product of each of the first four doses over the product of the fifth or marginal dose is equivalent to a rent. As before, a rise or fall in the price of the product will cause a rise or fall in the rent.

(iii) Still another way of demonstrating the nature of rent is as follows—



Costs (including minimum profits)

The law of diminishing returns may be otherwise expressed as that of increasing costs. In this diagram, suppose that *a′* (light portion only) is the cost (including minimum profit) of producing one unit; *b′* the cost of producing a second unit, and so on. The price at which all the units are sold is measured by the line *PP*. The marginal cost is measured by *e′*. The shaded area between *a′* and the price line is a rent, which also accrues but in diminishing degree to *b′*, *c′*, and *d′* The price just covers the cost *e′*, and in this case there is no rent. To produce another unit would cost *f′*, which is greater than the price received.

"No-rent" Land

The Ricardian theory of rent leads to the conclusion that land on the margin of cultivation pays no rent. In developed countries like England such land hardly exists. For this seeming anomaly there are several reasons—

(i) The marginal land which determines the rent payable in England need not be in this country: it could equally be overseas. The price of corn is determined on the international market. As the price rises or falls, rents at home vary accordingly; and if the worst land here is superior in productivity to the marginal land abroad (allowing for the cost of bringing the foreign produce here, which has to be deducted from the value of the gross output), it will yield a rent.

(ii) A tenant of a fairly large area cannot pick and choose, and pay rent only for the fertile tracts and at varying rates. Part of the land may be quite unproductive. An inclusive rent is calculated for the whole area, though actually it is paid only for the productive tracts. Thus the fact that no rent is paid for the non-productive land is concealed.

(iii) Land may have little or no value for the production of crops, but may possess a high amenity or other value.

Rent and Price

The relationship between rent and price has been much discussed by economists. The notion that rent is not a price-determining, but a price-determined, quantity, was developed by Ricardo:

> "The value of corn is regulated by the quantity of labour bestowed on its production on that quality of land, or with that portion of capital, which pays no rent. Corn is not high because a rent is paid, but a rent is paid because corn is high, and it has been justly observed that no reduction would take place in the price of corn although landlords should forgo the whole of their rent . . . Rent does not and cannot enter into the least degree as a component part of its price."

The same doctrine, with certain reservations, may be extended to commodities other than agricultural produce.

Briefly the stages in the argument are—

(*a*) Producers sell their goods for what they can get and not necessarily at as low a price as their expenses permit ;

(*b*) The price tends to equal the costs of the marginal producer (or of the marginal product) ;

(*c*) The position of the price fixes that of the margin, at which no rent is paid ;

(*d*) Producers above the margin receive a rent which increases or decreases with a rise or fall in the price ;

(*e*) Therefore, the economic rent is the result of the price, and not a factor in its determination.

Applied to *urban rents*, the same conclusion is broadly true. (Again, one must bear in mind that the heavy interest and other charges in the capital invested in buildings and services have to be deducted before the true rent is ascertained) A shopkeeper in a fashionable thoroughfare does not charge high prices because his economic rent is high. The economic rent is high because he is able to charge high prices. If the payment of net rent were abolished, the shopkeeper could and probably would maintain his level of prices, and thereby acquire a monopoly gain over and above his accustomed profit.

Even if the prices were no higher than elsewhere, there would still be a differential rent if the shopkeeper, owing to a situational advantage, had a larger turnover and therefore a greater profit. A tobacconist in a main thoroughfare pays a larger rent, yet charges no higher prices than a rival in a side street. The heavier rent comes, not out of better prices, but out of the greater volume of business. The conclusion that economic rent is not in itself a determining influence on price remains unaffected.

In general, the payment of wages, interest and profit determines largely the amount of labour, capital and enterprise that is forthcoming, but the payment of economic *rent has not a direct bearing on the supply of land. Similarly, the first group of incomes are price-determining, but rent is price-determined.*

Qualifications of the Ricardian Rent Doctrine

Some qualifications of the early theory of rent have already been made. Thus, rent of situation has been coupled with rent of fertility. Also, in the relationship to price, it has been shown that the volume of turnover may be an influential factor.

A further qualification is sometimes made in regard to *alternative uses* of land, each of which may have its own margin of cultivation. Thus, a plot may be used for growing wheat or barley; or it may serve for arable or pasture purposes; or it may be used for urban development, or it may be taken for pleasure parks or game preserves; or it may be acquired purely for the social position and prestige attaching to land-ownership. Judged from the standpoint of the purely commercial uses a piece of land might be marginal and bear no rent, or it might be marginal for one type of crop and not for another. And, as already observed, if it is employed for social or amenity purposes it may command a high value irrespective of its fertility. The payment required for land for one purpose might conceivably influence its employment for another. In so far as the margin itself was affected by the rent payable for an alternative use of the land, the rent might be considered to be a price-influencing factor.

Historical Illustrations of Rents and Prices

The operation of the law of rent has been illustrated very clearly in the course of the nineteenth and twentieth centuries. During the Napoleonic Wars the shortage of corn supplies, combined with the high tariffs on imported corn, contributed to a considerable rise in prices. Landowners and farmers made large incomes, and found it advantageous to cultivate the inferior land, hitherto deemed unprofitable. The rise in prices thus lowered the margin of cultivation and raised the rents of the superior lands Many farmers, thinking the good times would continue, heavily committed themselves financially. When the wars ended, prices gradually declined and, despite the protection afforded by the Corn Laws, many farmers were ruined. Rents fell with the prices.

In subsequent years, especially those during and following a war, whenever prices of corn rose or fell, rents almost invariably moved likewise. The Crimean War, the United States Civil War, the Franco-Prussian War, by cutting off foreign supplies and in other ways all helped to raise the price of corn, and rents rose in consequence. When, in the 'seventies and onwards, foreign corn came into Britain in increasing quantities, prices fell continuously, and so did the rents.

During and following the war of 1914–18 the same trend of prices and rents was experienced. The reduction of foreign supplies and increased demands on our own produce caused prices to rise. The productivity of the land resources at home was increased, for, apart from the fact that owners were compelled to put more land into cultivation, the high prices, with a guaranteed minimum, made it profitable to cultivate relatively inferior land and also to cultivate more intensively. The general result was a rise in the economic rent. State control of money, rents and prices complicated matters, but did not hide the real tendency In the subsequent years, much land went into disuse; the margin of cultivation rose, and rents declined.

Events during the war of 1939–45 followed a similar course The population had more than ever to depend on home-grown supplies, hitherto inferior land was utilized for growing food, and values, where they were not subject to control, rose accordingly. Until now, more than a decade since the end of the war, there has been no repetition of the previous post-war experience; in view of Britain's altered position in relation to the rest of the world and the necessity for making the fullest use of home resources, it is unlikely that the same proportion of land brought under cultivation will be permitted to go into disuse.

Summary of Influences on Rent

The principal factors influencing rent may be shortly summarized.

A fall in rents may be due to—

(*a*) Improvements in methods of cultivation. There is less resort to inferior lands, the difference between the best and worst land under cultivation diminishes, and therefore rents tend to fall.

(*b*) Improvements in transport. The effect is much the same Foreign corn is brought into this country and reduces the pressure on the inferior land here Similarly, railways and other travelling facilities may ease the pressure on congested urban areas, and so restrain the tendency for town rents to soar.

(*c*) Development of substitutes. New foods serve to reduce the demand for corn crops, the fall in the price of which leads to a reduction in the rent of agricultural land

A rise in rents may be due to—

(*a*) Growth of population and improved standard of life, entailing an increased demand Sub-marginal land is brought into cultivation, and rents rise

(*b*) Increased pressure in centres of population on dwelling and business sites.

(*c*) Wars and other disturbances, which increase prices and therefore rents.

In practice the one set of influences tends to counteract the other, but, on the whole, the tendencies in an upward direction have proved to be the stronger.

Section 2. Applications of the Doctrine of Rent

Rent Elements in Other Incomes

Economists in the latter part of the nineteenth century extended the doctrine of rent so as to liken it to surplus elements in other forms of income. The following are some typical applications of the theory—

(i) **As Applied to Interest: " Quasi-rent."** Suppose there is a sudden boom in foreign trade, and a great demand for shipping Freight charges rise and large profits are made by the shipping companies. Ships take a long time to build, and a considerable period may elapse before competition from new ships forces the charges down The earnings of the ships during the interim period (allowing, of course, for more rapid depreciation and similar charges) resemble a rent, for they represent the short-period income from property the supply of which is fixed in relation to a growing demand Like sub-marginal land, inferior vessels may be pressed into service, they in turn become marginal, and the receipts from the superior ships rise. When further supplies of shipping are available and freights fall, it no longer pays to employ these inferior vessels, the margin rises, and the receipts from the superior ships fall

In a short period, therefore, the whole return from fixed capital partakes of the nature of rent. The short-period payment for those agents of production, the supply of which, though alterable in a long period, is fixed in a short period, is sometimes described as a *quasi-rent.*

(ii) **As Applied to Profits.** Suppose there are two firms of similar size and situation, equally equipped and employing the same amount and quality of labour, but that one of them, owing to some special advantage (such as, for instance, the possession of stocks of materials bought when prices were exceptionally low), can produce a given article at a lower cost than the other. If the more fortunate firm can sell all its output at the price that is necessary to cover the costs of the other firm, it will do so. The profits it makes over and above those of its rival firm may be said to resemble an economic rent.

It is the differential gains, of course, that have no place in the price of the article, not what have been termed the normal profits. The latter must be considered a constituent element in marginal costs, and therefore in the supply price. But whereas marginal land is still cultivated, though it pays no rent, the marginal firm, must make a profit, for otherwise it would go out of existence. The seeming discrepancy is partly overcome by Marshall's conception of the "representative firm." This firm is not marginal in the sense that a slight fall in the price of the product or slight rise in costs would cause it to cease operations. It is "one which has had a fairly long life, and fair success, which is managed with normal ability, and which has normal access to the economies, external and internal," in the system of production generally. Prices tend to adjust themselves to the cost of production, not of the strictly marginal firm, but of the representative firm. A concern which produces more economically than this firm, but can dispose of its products at the price which the latter finds necessary, makes a surplus profit akin to a rent.

(iii) **As Applied to Personal Earnings: "Rent of Ability."** An element of rent can often be found in personal incomes, though its extent cannot as a rule be defined with any precision. An obvious example is to be found in the large incomes of successful lawyers or surgeons who, because of their special abilities, enjoy a semi-monopoly position. Their services would be of the same high quality if the reward were more modest, but in their favourable circumstances they are able, without greater effort, to charge considerable fees. Similar considerations apply, though not usually in the same degree, to the payment of wages. A workman whose personal qualities are superior to those of another may on that account receive a greater remuneration. The additional income in such cases is commonly termed a *rent of ability*

It may be urged by way of qualification that the extra receipts, whether of the professional or the manual worker, are largely an interest on the capital originally expended on training, and that they should not therefore be classified as "unearned." In so far as a capital outlay is incurred, an appropriate deduction from gross receipts for interest is legitimate, but it is usually found that the resultant addition to earnings is out of all proportion to, and may be several times the size of, the normal return to capital invested It could be equally maintained that the power of the recipient in his early years to lay out a capital sum, or to have it laid out for him, was in itself a major cause of the differential income, quite independently of the greater productivity that might accrue.[1]

General Conclusion on Rent

To sum up, rent is an element which may appear in all forms of income Though commonly associated with the payment to the landowner it may appear in some degree in the income of investors and entrepreneurs as well as in personal earnings. The main difference between rent of land and the payment for the other factors is that, while no alteration in rent can affect the supply and productivity of land, a change in interest, profits and wages does up to a point affect the supply of capital, enterprise, and labour. To that extent, interest, profits and wages are price-determining; rent is price-determined.

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[1] The "consumer's surplus" noted in Chapter VI, Sect 2, may be also likened to a rent In the same way as a producer above the margin would be willing if necessary to sell his product for less than the prevailing price, some consumers would be willing to pay more than the market price rather than go without the article The one is a producer's rent, the other a consumer's rent

PART IV

THE MECHANISM OF EXCHANGE

CHAPTER XII

THE FUNCTIONS OF MONEY

Section 1. *The Nature and Functions of Money*

ALTHOUGH it is convenient to study the organization of production and the mechanism of exchange in separate sections, it cannot be over-emphasized that they are closely interlocked, and that exchange is in fact only a part of the general scheme of production Goods are not finally produced until they have passed into the hands of the consumers, and the system of exchange has developed merely to facilitate this passage.

The Inconvenience of Barter

Modern exchange arose from a system of barter, i.e. trading without the use of money, which is still practised in simple communities. It was superseded because of its several defects—

(i) **Want of Coincidence.** Barter requires a double coincidence of things required and offered. If A and B are going to exchange their goods, A must have what B wants, and of the right amount, while B must have what A wants, also in the right amount. Further, they must both require each other's goods at the same time. If A wants bread and offers cloth, and B wants cloth but can only offer boots, one way out of the difficulty would be to discover a third person C, who wants boots and offers bread, and thus complete the "triangle of exchange."

But it is obvious that, as the division of labour extends, and people's wants grow in number and variety, this method of trading becomes increasingly difficult and in any but a small community must break down

Modern exchange, though outwardly complex in its mechanism, is essentially much simpler in operation than barter The need for a double coincidence is eliminated. Nowadays, a man sells his commodity to another in return for a recognized medium, with which he can purchase from a third person, or a number of persons, at various times if need be, the goods that he requires for his own consumption. The recognized medium we call *money*.

(ii) Want of Means of Subdivision. Some commodities are easier to split up into parts than others. Others are liable to lose in value when subdivided.

Suppose that a person's wealth takes the form of cattle or precious stones, neither of which can be subdivided without loss If he wished to purchase anything of small value by direct exchange, he would almost certainly lose by the transaction By the use of money, however, the difficulty is solved. The commodity is sold for a sum of money which can be subdivided into a number of units of small denomination. The expenditure of these can, if necessary, be spread over a period of time, thus demonstrating another advantage over barter.

(iii) **Want of Measure of Value.** Another drawback of barter is that, while A may offer what B wants, and B may offer what A wants, there is no satisfactory means of measuring the values of the respective commodities. A may have a large quantity of his stock, but B only a small amount of his. Obviously the stocks as such will not be exchanged. What, then, is to be the measure of value?

Here, again, the need for a monetary medium is made clear. Money measures the values of goods, but need not be actually handled. Two degrees of barter, therefore, may be distinguished—

(*a*) Where goods are exchanged for goods, without any system of evaluation ;

(*b*) Where, as a preliminary to direct exchange, a third commodity (i.e money) is used to measure the values In recent years a considerably amount of trading between countries has taken place on this basis

The Functions of Money

Money is a commodity chosen by common consent to serve as a means of exchange and of full discharge of obligations More fully defined it is "that which passes freely from hand to hand in full payment for goods, in final discharge of indebtedness, being accepted equally without reference to the character or credit of the person tendering it and without the intention on the part of the person receiving it himself to consume or enjoy or otherwise use it than by passing it on sooner or later in exchange." (Walker.)

The functions of money, which were indicated indirectly in considering the drawbacks of barter, may now be stated more positively—

(i) **Means of Payment.** Direct barter of goods for goods to any appreciable extent is impossible in modern communities. Goods are therefore exchanged for an intermediate selected commodity, which, in turn, is exchanged for other goods, probably in another place, at a different time, and in smaller or greater amount. This commodity, or money, thus fulfils the function of a medium of exchange. Since money is used in such one-sided transactions as tax-payments or gifts, when there is no exchange in the ordinary sense, the broader definition of the function as a means of payment is perhaps preferable.

(ii) **Measure of Value.** Money serves as a basis for the comparison of values in exchange; it represents a common denominator of value. Even in barter, as has been noted, money may be used indirectly, if the goods to be exchanged are first measured in terms of money. It will be shown below that, so far as standard money is concerned, the function of a measure has come to be more important than that of an actual medium.

(iii) **Standard for Deferred Payments.** Closely bound up with the service of money as a measure of value is the function as a standard for future payments, or, expressed another way, as a basis for credit transactions When payment is to be made at a future period, the parties to the contract require a medium which will have, as far as possible, the same exchange power in the future as at present. If one of the parties stands to lose by the transaction, trade is naturally impeded

> "Money is a form in which capital is held *in suspense* without loss. . . Money is not second-hand, it will always fetch itself, and it loses nothing by keeping . . Cattle are good enough for present bargains, but not for the forward- and backward-looking calculations of profit and loss " (Bagehot)

(iv) **Store of Value.** A man who wishes to conserve his wealth in some convenient form, always realizable as occasion requires, finds the money medium most suitable for his purpose, provided, of course, that inflation of prices does not reduce its purchasing power.[1]

Forms of Money

Anything that performs these functions may for practical purposes be regarded as money. The principal forms of money passing in this country are tabulated on page 185. In general terms they may be classified as—

(i) **Coinage.** Where the metal content is worth the face value, the coin is known as "full-bodied." Such coinage is becoming increasingly rare. Most coins nowadays are "token" money, their face value being greatly in excess of the value of the metal content.

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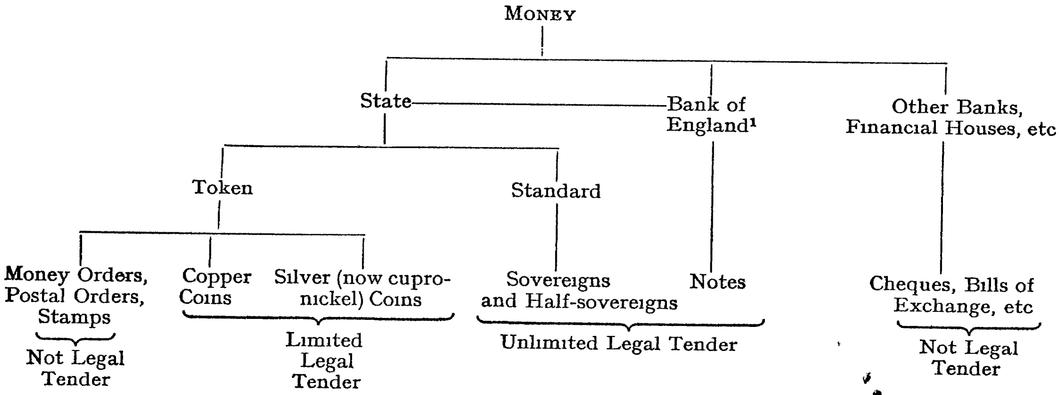
[1] See below, p. 200

THE BRITISH MONETARY SYSTEM


MONEY
State
Bank of England[1]
Other Banks, Financial Houses, etc
Token
Standard
Money Orders, Postal Orders, Stamps
Not Legal Tender
Copper Coins
Silver (now cupro-nickel) Coins
Limited Legal Tender
Sovereigns and Half-sovereigns
Notes
Unlimited Legal Tender
Cheques, Bills of Exchange, etc
Not Legal Tender

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[1] The Bank of England, since its nationalization in 1946, functions as a State Department Its notes have for practical purposes replaced gold coins for domestic transactions

(ii) Notes. Paper money, which is a pure token, has greatly increased in use in recent years. It may be issued by the State or other public authority, or by a bank, usually the central bank.

(iii) **Credit Instruments.** Cheques, bills of exchange, etc., serve as money to all intents and purposes, and comprise in fact the greater part of the effective money in use.

Money is described as *legal tender* when a person is obliged by law to accept it in payment of a debt He is under no obligation to accept money not so defined. Token money is declared to be limited legal tender up to certain amounts—e.g copper coins up to a shilling, nickel-brass 3d. pieces to 2s , and silver (or cupro-nickel) coins up to £2.

Fiat money is that which the State declares to be legal tender, though its content value may be little or nothing. Most of the fiat money consists of notes, though token coins may also be included in the term.

Section 2 Coinage and the Gold Standard

Qualities of Good Money Material

Many things have served as money at different stages of our history. Slaves, cattle, skins, furs and shells were employed before the metals gradually replaced them. Silver came to be widely used as a medium, but in turn was supplanted in most countries by gold. But, while gold satisfies the conditions of a standard coinage better than any other known commodity, the ideal material has still to be discovered.

The necessary qualities of a standard coinage in so far as it actually circulates as a medium are—

(i) *Utility.* The commodity must have a utility independent of the power to serve as money, in order that it will be generally acceptable. Cattle, skins, gold, etc , are desirable for the satisfaction they offer in themselves.

(ii) *Stability of Value.* The material selected still remains a commodity whose value is influenced by changes in supply and demand. Since the value of the monetary material measures the value of all other things, any alteration automatically affects the values of everything else. Consequently it is essential that the material chosen should be as constant in its value as possible.

(iii) *Portability and Compactness* This includes ***transportability*** without depreciation. Since money has to be moved about, it is necessary to concentrate the value into a convenient form. Iron would not be as satisfactory in this respect as the precious metals.

(iv) *Durability.* The money material should not deteriorate. Skins and corn were found unsuitable in this respect. Even among the metals there are some kinds less destructible than others. A metal that corrodes through exposure to the elements is not satisfactory.

(v) *Cognizability.* The material should be easily recognizable. A metallic medium should have a distinctive colouring; thus, nickel and silver coins circulating together would cause confusion.

(vi) *Homogeneity* The material should be of the same quality throughout and capable of standardization. Metals are obviously the best for this purpose.

(vii) *Divisibility.* The material should be capable of being divided without losing value. Again, metals show to advantage. Some of the older forms of money tended to lose heavily in value when broken up.

(viii) *Malleability* A material which permits of moulding and stamping is essential so long as the standard currency has to pass from hand to hand.

Of the above requisites utility and stability are still of first importance, even though the standard gold coinage has virtually disappeared from everyday use.

Advantages and Limitations of Gold

It is clear that, in the matter of divisibility, homogeneity, durability and malleability, metals are greatly superior to such early forms of money as cattle and skins As a standard, gold has a number of advantages. It may be put to alternative uses, and, when necessity arises, can be reclaimed from ornamental use and converted into bullion or coin Moreover, it is compact and cognizable, does not tarnish, and can be stored without loss.

Though the stability of the value of gold leaves much to be desired, no other single metal or other commodity has been discovered that serves the purpose better. An advantage of gold in this respect is that the world's stock is very large, in comparison with the annual output.[1] In normal times the demand for gold proceeds at about the same pace as the supply, and serious discrepancies are infrequent. During recent years, however, the demand for gold has greatly exceeded the supply, while the situation has been rendered even more difficult by a maldistribution among the countries of the world. The value of gold has thus proved to be less stable than might be expected of the commodity which is used as a standard medium.

With regard to portability, while gold has the highest specific value of all the coin-metals except platinum, it is too heavy and inconvenient for the large transactions that now occur daily. Further, the transport of gold involves a certain cost. A system of accounting has developed, and paper money and other credit instruments tend increasingly to take the place of gold. Even where the gold standard remains effective, the metal tends increasingly to serve as a basis of calculation rather than a material medium of exchange.

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[1] It is estimated that the annual addition to the world's stock is about 5 per cent Thus, even if the world's annual output were quickly increased, the effect on its exchange-value, though appreciable, would not be as great as if the gold were literally used up as quickly as it was produced

Provided there is proper control by the managing authorities, paper currency and credit instruments can function very effectively as money. These media, together with token coins, are found adequate for internal trade. For international payments, however, gold is still found necessary, but in recent years, as will be shown later, most countries have experienced considerable difficulty owing to the shortage of dollars and the consequent one-way movement of gold towards America

Gold and Silver Coinage

Gold was not always the single standard metal in the British coinage. It began to be coined regularly in 1344, but before then silver had been the standard medium (The pound was originally equivalent to 1 lb. of silver) From then until 1816 silver and gold were in circulation together as standard coinage, and frequent variations in their respective values were a constant source of anxiety.

Following the recoinage of silver in 1696, when full-weight coins were issued in place of the light and base coins, the gold coinage became over-rated (i.e. its bullion value was less than its face value), with the result that people preferred to use it in the place of the silver currency, which tended to go out of circulation.[1] In 1717, the value of the guinea as measured in silver was reduced from 21s. 6d. to 21s., and gold and silver coins were supposed to circulate together at a fixed ratio. But the silver currency was still under-rated and again tended to disappear

[1] See below, pp 193–4

In 1816 the whole system was reorganized, and gold became the single standard. The sovereign took the place of the guinea, and its weight was fixed at 123·27447 grains of standard gold, $\frac{11}{12}$ths or 22 carats fine, silver coins were reduced to the rank of tokens Other countries, too, came to adopt gold as the single standard.

Until 1925 the Mint accepted gold for coinage at £3 17s. 10½d per ounce, though normally the bullion was taken to the Bank of England, which was legally compelled to give coin in exchange at £3 17s. 9d per ounce[1] (The difference of 1½d was not a charge for coining, but in effect a compensation for loss of interest between the time of paying out coin and the minting of the bullion)

The gold standard was suspended during the first world war, restored for a while in the 'twenties, and suspended again in 1931 The events of this period are outlined in Chapter XXII.

Before 1914 silver coins to the value of 5s. 6d were made from an ounce of metal, $\frac{37}{40}$ths fine. As the price of silver was in those years much below 3s per ounce, the Mint made an appreciable profit on silver coins, even after paying the costs of minting and loss through wear.

By 1918 the price of silver had risen to over 5s. 6d. per ounce. This meant that the face value of silver coins was now below their bullion value. In consequence the coins began to go out of circulation. To restore the position the State in 1920 introduced a cheaper silver-nickel currency. This coinage remained unaltered until 1946, when it was superseded by a cupro-nickel currency.

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[1] Gold coinage is said to be "free" in that bullion is taken in exchange for coinage up to any amount, "gratuitous" in that no charge is made for minting

Where a charge is made by a State to cover the cost of minting, it is known as a "Mintage" or "Brassage"

Any toll that is exacted over and above the brassage is described as a "Seignorage"

Though some purists regarded the decline and disappearance of the silver currency as a form of debasement, this view was somewhat unrealistic in that the coinage had for long served as tokens only.

Gold Standard Systems

There are three systems by which the price of gold may be fixed, within narrow limits, in terms of a country's currency

(*a*) **Gold Specie Standard.** This standard operates when a government issues gold coins of a certain weight The authorities must be willing on demand to accept bullion and convert a given weight into a definite number of coins of fixed value; also any person must be free to melt down these coins or to export them This was the system prevailing in the United Kingdom before 1914.

(*b*) **Gold Bullion Standard.** Under this system the price of gold in terms of a country's currency is fixed without the use of gold coins For example, from 1925 to 1931 the price of gold in this country in terms of pounds was fixed, though gold coinage had long disappeared from circulation. Gold bullion could be obtained at the Bank of England in exchange for pound notes, provided that not less than 400 oz of fine gold was purchased This minimum meant in effect that gold would not be available for home purposes, though it could be obtained for large foreign payments

(*c*) **Gold Exchange Standard.** This system is more complex than the other two. A country determines the value of its money in terms of gold by fixing the rate of exchange between its own currency and that of another country employing a gold basis Thus there may not be any gold in a country, but if its central bank holds a reserve of notes or equivalent credits of another country which is on the gold specie or bullion standard, it can fix the price of gold in terms of its own currency.

Section 3. Paper Money

Paper Tokens

A coin may be regarded as an order on a person to supply a certain quantity of goods, and is acceptable because its function is continuous and carries on this order from person to person. Gold, silver, and copper coins are orders on goods, subject to the respective conditions of legal tender. Equally effective as an order, and therefore as money, may be a piece of paper, issued and controlled by authority. A pound note and a half-crown have but in common that neither contains full value in itself, this is simply a token, though in different degree, serving in the place of standard money.

Provided that there is no abuse in the conditions of issue, paper notes may perform the functions of money as well as gold and, in some cases, even better. Coins gradually lose in metal content by constant wear and tear, and have periodically to be replaced at public cost. Further, if a gold coin were to be lost, not only would the late owner be the sufferer, but the community as a whole would be so much the poorer. The destruction of a paper note, on the other hand, while it would involve a reduction in the wealth of the former possessor, would cancel a claim on the issuing body, and thereby inflict no loss on the nation in general.[1]

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[1] Paper currency is said to be convertible when the issuing authority is bound on demand to give standard coinage or bullion in exchange It is described as fiduciary when it is backed not so much by specie as by the faith which the promissor can inspire Inconvertible paper money may be given the force of legal tender, but its effectiveness and acceptability depend on the powers and trustworthiness of the issuing authorities Fiduciary money may be convertible or inconvertible according to the circumstances.

The British Currency note issue was introduced in 1914, and in 1928 was amalgamated with the Bank of England note issue

The following table indicates the increase in the currency circulation during recent years.

CURRENCY CIRCULATION[1]
£ million

	1938	1951	1953	1955	1957	1958	1959 (Aug)
Notes and Coin Outstanding							
Total	631	1,617	1,824	2,068	2,301	2,379	2,516
Bank of England Notes	529	1,383	1,570	1,795	1,998	2,068	2,200
Scottish Bank Notes	23	74	90	102	117	119	122
Northern Irish Bank Notes	5	9	8	8	10	9	9
Coin (estimated)	73	151	155	163	176	182	185
Held by Banks							
Bank of England Reserve	45	41	41	37	34	36	35
Scottish Banks	24	78	94	107	122	125	129
Northern Irish Banks	3	9	8	9	10	10	10
London Clearing Banks	117	197	218	258	293	304	334
Currency in Public Circulation	442	1,291	1,462	1,657	1,842	1,905	2,007
Ditto as percentage of 1954	28	292	94	107	119	123	129

Gresham's Law

Reference has already been made to the tendency for over-rated to drive under-rated money out of circulation. This tendency is in accordance with "Gresham's Law,"[2] which, in simple terms, states that, *where good and bad money are circulating together as legal tender, the bad money tends to drive out the good*

When the law was first formulated, it referred to debased coinage only, but it can be shown to apply equally to depreciated coinage not necessarily debased, and also to depreciated paper currencies.[3]

[1] *Monthly Digest of Statistics*

[2] This law is incorrectly attributed to Sir Thomas Gresham, who was the founder of the Royal Exchange and financial counsellor to Queen Elizabeth It had been propounded by earlier thinkers, notably Nicholas Oresme, minister to the French King, Charles V, in the fourteenth century (See Appendix)

[3] By *debasement* is meant a reduction in the weight or quality of the metal in a coin, causing the value to be misrepresented *Depreciation*

(i) *When good and bad coins of the same metal circulate together as legal tender*, the full-weight coins tend to be kept back from circulation, and may be hoarded or melted down. Since the laws of legal tender apply only in the country of issue, foreigners will not accept the coins except at their bullion value Consequently there is a tendency to export the good coinage that commands a higher value abroad than at home.

(ii) *When coins of two different metals circulate in a bimetallic system, and the market ratio is different from the Mint ratio*, and since both kinds of coins are legal tender up to any amount, the tendency will be for the coins with a smaller bullion value to drive out of circulation those coins with a higher bullion value

(iii) *When an inconvertible paper currency is circulating together with full-value coinage*, and they are both unlimited legal tender, the coinage tends to disappear, and the resultant shortage of currency may induce the State to issue still further quantities of paper.

In the long run, however, the inferior currency may bring about such unwelcome results that good money has to be re-introduced to drive out the bad. This has happened on several occasions during the past decade Hence, over a long period, Gresham's Law does not necessarily operate, and, in favourable circumstances, the reverse of it is nearer the truth.

Signs of Over-issue of Notes

An over-issue of paper money is usually indicated by some, if not all, of the following signs.

(i) *Premium on gold*. One of the immediate consequences of an over-issue of notes is a rise in the value

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refers to the diminished purchasing value of money, and may be the result of debasement of coinage or inconvertibility of notes, or to changes in the supply of money generally *Appreciation*, on the contrary, denotes an increase in the purchasing value of money of gold. This is largely due to the demands of foreigners, who are unwilling to accept the paper currency, unless at a discount. In the home country as well there may be a marked preference for gold over paper.

(ii) *Disappearance of gold.* In accordance with Gresham's Law, the gold tends to be driven out of circulation by hoarding, melting, and exporting.

(iii) *Rise in prices* In accordance with the Quantity Theory of money and prices, which will be explained in the next chapter, a rise in the general price level tends to follow an increase in the amount of effective money in circulation

(iv) *Duplication of prices* Where gold and paper circulate together there may be the peculiar phenomenon of two sets of prices (i e. relatively low gold prices and high paper prices) for the same things, though such a condition can obtain only where the legal tender laws are ineffective.

(v) *Adverse foreign exchange.* The bearing of the conditions of note issue on the rate of exchange is discussed in Chapter XVI, Sect 2.

CHAPTER XIII

MONEY AND PRICES

The Value of Money

THE value of money is the power that it has in exchange for other commodities, in short, its value is its purchasing power [1] A general rise in prices denotes a fall in the value of money, and a fall in prices means a rise in the value of money.

A general rise in prices may, of course, be accompanied by a decline in the prices of particular commodities, and *vice versa.* Or the prices of particular commodities may move in the same direction as general prices, but not in the same degree. But it is only by regarding price movements as a whole that one can express changes in the value of money.

It was shown in the chapters on value how an increase or decrease in the supply of anything tended respectively to lower or raise its value, and how an increase or decrease in the demand for anything tended respectively to raise or lower its value Though the supply of and demand for money are subject to special conditions, such as for instance the arbitrary issue by the central authority and the control of particular prices, the general principles of value still apply.

It may be generalized that—

(1) *An increase in the quantity of money,* unaccompanied by a corresponding increase in the quantity of

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[1] The *value of money* must be distinguished from the *price of money* The latter is the money market term for the charge that is made for the use of money for a certain period, and is equivalent to the rate of interest or discount See pp 224–5

goods, tends to lower the value of money (i.e. to raise prices);

(ii) *A decrease in the quantity of money*, unaccompanied by a corresponding decrease in the quantity of goods, tends to raise the value of money (i.e. to lower prices);

(iii) *An increase in the quantity of goods*, unaccompanied by a corresponding increase in the quantity of money, tends to raise the value of money (i.e. to lower prices), and that

(iv) *A decrease in the quantity of goods*, unaccompanied by a corresponding decrease in the quantity of money, tends to lower the value of money (i.e. to raise prices).

The Quantity Theory of Money and Prices

The above tendencies form the basis of the Quantity Theory of money and prices As first conceived, the theory stated that general prices are directly proportionate to the quantity of currency in circulation, i.e. an increase by a given amount of money automatically brings about a corresponding rise in the price level.

The reasoning in its original form may be briefly outlined. Imagine an isolated country with a given number of units of currency and an equal number of commodities offered for sale, all of the same value. If each commodity were exchanged once, the price would be 1 unit of money. Suppose that the supply of money for some reason doubled in quantity, the amount of goods remaining the same. Each commodity would now exchange for two units of money; i.e. the general level of prices would be doubled. Suppose, on the contrary, that the amount of currency were halved, or, what comes to the same thing, that the number of commodities offered for sale were doubled In such circumstances each unit of money would now be equivalent in exchange to two commodities.

It would, in a sense, have twice as much work to perform as before, and the general price level would be halved

Modifications of the Quantity Theory

In practice, however, it is found that price movements do not correspond to changes in money supplies in the exact ratio that the theory in its original and over-simplified form suggested Several qualifications have to be made before the theory can be reconciled with actual conditions.

(i) *Notes and credit instruments.* Anything that does the work of money naturally affects the ratio between purchasing medium and the quantity of goods. Thus, an increase in the amount of paper currency or in the issues of credit tends to send up the demand for goods, with a consequent rise in general prices. When note and credit issues are contracted prices tend to fall

(ii) *Rapidity of circulation.* It needs little demonstration to show that hoarding, by reducing the quantity of effective money, has the same restrictive tendency on prices as a physical reduction in the total quantity of money. Conversely, the repeated use of the same money has an effect similar to that of an increase in actual quantity. Thus, a pound note, which, in a given period, circulates five times, does as much work and exercises the same effect on prices as a five-pound note which changes hands only once.

(iii) *Volume of trade.* On the other hand, an increase in the volume of trade tends to lower prices, for it means that the money available has more work to do. It entails a greater demand for money, which thereby rises in value as a purchasing medium.

The volume of transactions is influenced by—

(*a*) the total amount of goods produced;

(*b*) the efficiency and organization of production;

(*c*) the number of times the goods change hands before final consumption.

In brief, the Quantity Theory in its modified form states that **the level of general prices tends to vary directly with the quantity of money of all kinds and the rapidity of circulation (together equivalent to the supply of effective money), and inversely with the volume of trade (equivalent to the demand for money).**

Qualifications of the Quantity Theory

A caution is necessary in applying the Quantity Theory, which, like other economic laws, should be regarded as a statement of tendency only Various schemes for the reform of the currency have been devised at different times, resting largely on the assumption of an automatic reaction of the quantity of money on the level of prices. But the currents and counter-currents in modern exchange are too numerous and diverse to ensure that manipulation of money supplies will have the desired effects In a short period the amount of money may be reduced and prices still continue to rise, conversely an increased money supply may be accompanied by a fall in prices.

Another qualification places emphasis on the *stock* as distinct from the *flow* of money. A person may prefer to hold rather than spend money ("liquidity preference"), thereby influencing current demand and prices. In other ways, too, a variation in the amount of money may set up a train of circumstances, psychological as well as economic, that increase or reduce prices in a relatively greater degree Thus, for example, an increase in the volume of trade may bring about a more than proportionate addition to the supplies of credit, and prices may rise in consequence Or a sudden restriction in credit facilities may cause traders to throw their stocks upon the market to such an extent that prices fall to an abnormally low level.

Inflation and Deflation

Under ordinary conditions adjustments of the amount of effective money in circulation to the changes in the volume of trade are more or less automatically brought about by the mechanism of finance. Such price changes as occur are the result of ordinary economic forces. In times of difficulty, however (as for instance in war and post-war years), governments have found it necessary or expedient to issue additional currency or to create credits so as to provide for their immediate needs.

Inflation is the term given to the expansion of money supplies, whether in currency or credit, in excess of the amount justified by the state of trade, resulting therefore in a general rise in prices. Inflation through an over-issue of currency is a form of proportionate taxation which is open to criticism on account of its inequitable apportionment and incidence.[1]

Deflation denotes a contraction in the amount of effective money in greater degree than the volume of trade, with the result that the general level of prices is reduced. The practice may be employed after a period of deliberate inflation as a means of restoring faith in the currency both at home and abroad. Where the purpose is to curb a continuing tendency to a rise in prices, as was the case in Britain in the years following both world wars, the method is described as *disinflation,* but the difference is chiefly one of terminology.

"Inflation breeds inflation." Once an excessive amount of money has been put into circulation and prices have begun to rise, there is a tendency for this increase to outstrip the initial expansion in currency. There is a call for further currency to cope with the new price level, and a vicious spiral may result. It is easier to succumb to the temptation of inflation than later on to undergo the painful process of deflation.

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[1] See p. 279

Inflation need not result from the issue of new money and credit if these are instrumental in swelling the volume of goods on the market. In the interval, however, between the capital outlay and the eventual increase in supplies the pressure of money may engender an inflationary situation Similarly, as has been evident in recent years, the extent to which increases in wages may be regarded as inflationary depends largely on the extent to which they keep pace with, or go ahead of, improvements in productivity or lowering of other costs.

Measurement of Price Movements: Index Numbers

Changes in the prices of single commodities are of little assistance in computing the value of money, especially as particular prices may be rising while the general price level is falling. But if a large number of representative articles and services are taken, and their general average trend is observed, movements in the value of money can be more satisfactorily deduced.

In the calculation of an index number of prices, a certain year is taken as a basis of comparison, the index for that year being regarded as 100. An index number of (say) 115 denotes an increase of 15 points in the general level of prices. An index of 85 denotes a fall of 15 points.

Index numbers may be computed for wholesale or retail price changes, but the same general principles are followed—

(1) A large number of commodities should be taken A comprehensive index number should include the cost of services as well as of material commodities.

(ii) The commodities should be representative of as many different types as possible A preponderance of foodstuffs or manufactured articles in the selection would give an unbalanced and misleading result.

(iii) The commodities should be "weighted" according to the degree in which they enter into consumption. If a simple average were taken, a rise in the price of (say) bread might appear to be cancelled by a fall in the price of (say) silk, thus leaving the index number unaffected, despite the fact that much greater quantities of bread are consumed than of silk. In order to prevent such error and discrepancy the prices of the selected commodities are given different weights in the calculation, estimated to represent their relative importance in the aggregate demand, thereby resulting in a more accurate index of changes in the prices as a whole.[1]

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[1] Suppose, for example, that a loaf of bread costs 8d , and that a yard of silk cloth costs £1, and that subsequently the price of bread rises to 1s and that of the silk length falls to 10s

If a simple average were taken,

First period		Second period	
Bread	= 100	Bread	= 150
Silk	= 100	Silk	= 50
Average Index No	= 100	Average Index No	= 100

Such a calculation would suggest that in the second period there is no depreciation of the value of money When properly weighted, however, the index number for the second period affords a more realistic measurement. Suppose bread and silk are consumed in the proportions of 7 to 1

Then—

First period		Second period.	
Bread (7 units)	= 700	Bread (7 units)	=1050
Silk	= 100	Silk	= 50
Average of 8 units	= 100	Average of 8 units	= 137½

I.e. the weighted index number for bread and silk is 137½

Limitations of Index Numbers

No matter how wide the basis and elaborate the reckoning, an index number is no more than an approximation, and cannot be expected to apply to all individual circumstances. Being an average it must necessarily differ from the computations for particular cases or groups Different people buy commodities in varying quantities and qualities. An index number based on the purchases of a "representative" family might not hold good for a larger or smaller family, or one with a larger or smaller income. For instance, milk enters to a large extent into the budget of a family with several children, but represents only a small proportion of the expenditure of a small family. Also, the nature of the expenditure may vary from time to time, due either to changes in taste or standards of consumption. In any case, changes may occur in the qualities of the goods which a quantitative index cannot reflect.

Index of Retail Prices

The following table records the indices of retail prices in the main groups for the years 1935–46.

INDEX OF RETAIL PRICES, 1935–46
September, 1939 = 100

Year	All Items	Food	Clothing	Fuel and Light	Rent
1935	92	91	90	93	97
1936	95	94	91	96	98
1937	99	101	97	98	98
1938	101	102	100	99	99
1939	102	102	103	101	100
1940	119	119	137	115	101
1941	128	122	177	125	101
1942	129	117	192	129	101
1943	128	120	169	135	101
1944	130	122	166	141	101
1945	131	123	167	150	102
1946	131	122	166	152	103

In June, 1947, the Ministry of Labour and National Service introduced a more precise interim index, but based upon the pre-war pattern of consumption. The indices

INTERIM INDEX OF RETAIL PRICES, 1947–55
Indices for Main Groups
Monthly Averages

	All Items	Food	Rent and Rates	Clothing	Fuel and Light	Durable Household Goods	Miscellaneous Goods	Services	Alcoholic Drink	Tobacco	
	17 June, 1947 = 100										
Weights	1,000	348	88	97	65	71	35	79	217		
1948	108	108	99	109	111	108	110	105	109		
1949	111	114	100	118	113	108	112	105	108		
1950	114	123	101	120	116	112	113	108	105		
1951	125	136	103	138	128	132	128	118	106		
1952 (Jan)	132	150	104	147	140	137	137	124	108		
	15 January, 1952 = 100										All Items
Weights	1,000	399	72	98	66	62	44	91	78	90	17 June, 1947 = 100
1952	103	105	102	98	101	99	102	104	101	100	136
1953	106	111	108	96	106	96	101	108	101	100	140
1954	108	114	112	96	111	95	100	111	102	100	143
1955	113	123	115	96	118	97	102	115	103	101	149
1956 (Jan)	116	125	118	99	128	102	107	119	103	103	153

INDEX OF RETAIL PRICES, 1956–59

	All Items	Food	Alcoholic Drink	Tobacco	Housing	Fuel and Light	Durable Household Goods	Clothing and Footwear	Transport and Vehicles	Miscellaneous Goods	Services
	17 January, 1956 = 100										
Weights	1,000	350	71	80	87	55	66	106	68	59	58
1956	102	107	101	103	103	101	101	101	102	102	103
1957	106	105	104	106	110	108	101	107	110	108	109
1958	109	107	106	108	122	113	100	103	113	113	114
1959 (Aug)	109	108	98	108	128	114	98	102	115	113	116

for the main groups, together with the respective weights, are given in the first section of the table on p. 204 In January, 1952, this set of weights was replaced by a new series, related to the pattern of consumption in 1950 The indices on the revised basis are given in the second section. The final column permits of comparison with 1947 prices.

In February, 1956, a new index was introduced. A revised system of weights was adopted based on ascertained consumption in 1953–54, expressed in terms of January, 1956, prices The lower table gives the indices for 1956–59.

Effects of Price Movements

Movements in general prices have unequal effects on different sections of the people. The effects of falling prices may be noted first.

(i) People whose incomes are fixed either by contract or by authority (such as fixed-interest receivers or pensioners) enjoy an increase in their real income as prices decline. On the assumption that the total real income of the nation remains the same, the receivers of fixed money incomes benefit at the expense of the rest.

(ii) Manufacturers and other employers may find that their selling prices fall more rapidly than certain of their costs, notably wages, rentals, and sundry fixed charges, and tend to restrict their output in consequence. In anticipation of a continued drop in prices, sellers may throw their stocks upon the market to an excessive degree, thus intensifying the price decline.

(iii) Raw material and wholesale prices fall more quickly than retail prices, since conditions are more competitive than in the retail market. In so far as wages are determined by the retail price level there is in consequence a certain time-lag in wage adjustments.

(iv) Falling prices and profits tend to discourage new investment, and the demand for production goods falls

PRICE MOVEMENTS IN BRITAIN

Years	Price Movements	Monetary and Industrial Conditions
1800–1809	Rise	Napoleonic Wars Bank-note inflation
1809–1849	Fall	Increase in volume of production Relative shortage of money Tariff reductions
1849–1874	Rise	Gold supplies from California and Australia Development of banking and credit system
1874–1896	Fall	Increased demand for gold for currency Expansion of industry and therefore of demand for gold and credit
1896–1914	Rise	Gold supplies from South Africa and extension of banking and credit facilities
1914–1920	Rise	World War I Inflation Restriction of normal production
1920–1922	Fall	Reaction following abnormal war years Increased production Deflationist policy
1922–1925	Rise	Temporary check
1925–1931	Fall	Deflationist movement continued Improvement to 1929 followed by world depression
1931–1939	Rise	General recovery Set-back in 1937–38
1939–1959	Rise	World War II Post-war crises followed by general recovery Inflationary trend checked [1]

[1] For a fuller account of the changes since the First World War see Chapter XXII

more rapidly than that for consumption goods. Industrial development may thus be retarded.

(v) The revenue of the State from taxation is liable to fall, since realized profits and therefore income tax yield are less, estates subject to death duties are valued at a correspondingly lower figure, *ad valorem* duties provide less as the commodities become cheaper, and so on. Furthermore, as a large part of public expenditure is of a fixed contractual character (payments on national debt, pensions, etc.), the real burden to the taxpayer is apt to be greater.

Rising prices have results which are roughly the opposite of those just enumerated. They are beneficial to manufacturers and others whose products rise in price faster than the expenses of production. They induce an increased demand for production goods and a greater employment therefore of capital They may also have a useful psychological effect in stimulating economic undertakings, provided they do not lead to injurious speculation On the other hand, they are harmful to those whose incomes do not rise at the same rate.

On the whole, steady prices are the most advantageous to traders and industrialists in general, especially over a long period. They enable forecasts to be made with greater accuracy, and thus facilitate long-period contracts Production and employment are rendered more continuous and the incomes of all classes more regular[1]

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[1] *Money and Relative Prices*, In the above account reference has been made only to the causal relationship between the *total* quantity of money, the *general* level of prices, and the *total* volume of production The theorizing in its present state can be criticized on the ground that it is not these aggregates that count in everyday life so much as individual variations It is considered insufficient to regard relative prices merely as "frictional" manifestations, arising from disturbances in the total supplies of money and the general price level

Recent developments in this theory are closely bound up with the study of trade fluctuations (see Chapter XVII) Prof Hayek, for example (*Prices and Production*), maintains that any change in the total quantity of money must influence relative prices, and since it is relative prices that directly influence the character and direction of production, changes in total volume of money supplies must have an effect on production He criticizes the theory that if the general price level remains constant, economic equilibrium is not disturbed by monetary changes Such criticisms, which it is impracticable to deal with adequately in an elementary work, would, if accepted, lead to the abandonment of a theory of a direct relationship between money and the general price level and substitute a theory that attempts to trace the connection between money and relative prices, and the effects of the latter on production

CHAPTER XIV

CREDIT AND BANKING

Section 1. *The Growth of Credit and Banking*

Characteristics of the Credit System

BEFORE proceeding to describe the development and operation of the credit mechanism, it may be useful to note briefly its part in the monetary system and in the wider economy.

(i) **Functions and Benefits.**

(*a*) The credit system economizes in the use of an expensive gold currency, which is altogether insufficient in quantity to meet modern requirements.

(*b*) It facilitates large-scale enterprise.

(*c*) It stimulates and finances production in anticipation of demand

(*d*) It permits wealth to be transferred to quarters where more economic use can be made of it.

(*e*) It enables payments to be made at convenient times, and so tides over periods of difficulty.

(*f*) If the issue of credit is properly regulated, it tends to stabilize trade and reduce fluctuations in prices.

(ii) **Limitations and Dangers.**

(*a*) An over-issue of credit may promote unwise production and expansion, precarious speculation, with danger of "over-production" and serious fluctuations in prices and trade

(*b*) Too easy credit may encourage extravagance.

(*c*) Where a firm is near insolvency, the granting of credit may only postpone and intensify the ultimate failure Temporary concealment of its weaknesses may involve creditors and others in loss.

Evolution of Credit and Banking

The beginnings of credit and banking may be traced to the early goldsmiths, with whom wealth used to be deposited for safe custody, and who made a charge for the service. A depositor who wanted to pay a debt would at first withdraw his money and pay it to his creditor, who might redeposit it with the same goldsmith This method proving cumbersome, a more convenient and economical system arose, under which the goldsmith, who was well known and trusted, gave a receipt for the money to the depositor, drawn up in such a way that it entitled *any* holder to claim the specified amount of money from the goldsmith. The depositor would now pay over this receipt to the creditor, who would take the claim to the goldsmith. The first man would have his account debited, and the second would either receive the cash or have his account credited with the sum. Thus, claims of one party on another could be settled without necessarily handling coin.

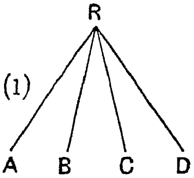
But the sum deposited might be so large that the receipt for the total amount proved inconvenient for paying debts. Hence a depositor might prefer to be given several receipts of smaller denominations These were, in effect, the early form of bank notes At a later stage cheques, which were specific orders on the banker, were more commonly used.

The goldsmiths or bankers soon discovered that, although some money was continuously being withdrawn, the amount demanded at any time was almost invariably less than the total sum in hand Part of the funds could in effect be segregated and rarely touched. At the same time they found that they were being asked for loans on good security. Naturally they would think of the money lying idle, and of the possibility of substituting securities for it. The next step in banking practice, therefore, would be, with the consent of the depositor, to lend out some of the surplus funds So long as safety was assured, the depositor would be unlikely to object, for instead of having to make a payment for the "safe deposit" service, he would now receive an interest on his money.

Growth of the Banking System

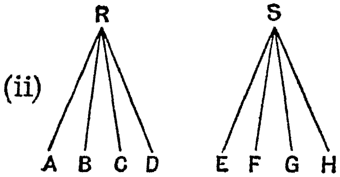
The evolution of the banking system may be made clearer by a few illustrations.

(i) Suppose R to be the only bank in a small town, and that A, B, C, and D are townsmen who keep their accounts only with R. If A wishes to pay C some money, he draws a cheque on R and hands it to C, who pays it into the bank A's account is debited with the amount and C's account is credited



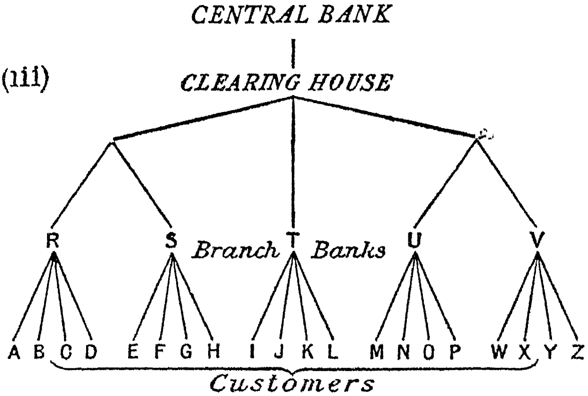
(ii) Suppose another bank, S, commences business in the town and receives the custom of E, F, G, H.

If A wishes to pay G a sum of money, he draws a cheque on R, and hands it to G, who deposits it with S. In the same way, cheques drawn on S are deposited with R. At the end of a day or other agreed period, representatives of R and S meet and present each other with a claim equal to the total of all cheques received on behalf of the other bank. At this stage the difference may be paid in cash



(iii) The need to pay the difference in cash is obviated when the several banks set up a Clearing House, at which representatives of R, S, etc., periodically gather together, balance their mutual indebtedness, and pay the differences by drafts on the deposits that each bank keeps at the central bank.[1]

(iii)



Functions of Banks

The general function of a banker has been defined as *the exchange of money for credit, and credit for money.* His particular functions are—

(1) Holding Deposits.

(*a*) *On Current Account,* whereby the banker undertakes to repay deposits to the customer on demand. Usually the banks allow no interest on such accounts, and may charge a commission for the service rendered.

(*b*) *On Deposit Account,* whereby the banker is given notice of intended withdrawal, and allows interest according to the length of notice given.

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[1] The London Bankers' Clearing House used to consist of three sections, the Town Clearing (City area), Metropolitan Clearing (London Postal District), and the Country Clearing During the war the two latter were combined with a large part of the Town Clearing Besides the London Clearing House there are local clearings in the main provincial centres In 1956 the total London clearings averaged £532 million per working day, and the provincial clearings £8 million

(ii) **Granting Loans.** The bank lends money against security at certain rates of interest As will be shown below, the borrower's account is credited with the agreed amount up to which cheques may be drawn.

(iii) **Discounting Bills of Exchange.** A holder of a bill payable at a future date may discount it at a bank, for which he receives its "present worth," calculated at the current market rate. Bills are a handy asset for a bank to hold and, on maturity, turn into cash.

(iv) **Balancing of Payments.** This is the collection and payment of cheques by the Clearing House System, already described

(v) **Acting as Agent.** A banker serves in various ways as agent for customers and other banks—

(*a*) Collection and payment of interest and dividend on stocks and shares;
(*b*) Purchase and sale of stocks and shares;
(*c*) Transactions in foreign exchanges,
(*d*) Service as trustee, executor, etc ;
(*e*) Provision of safe custody of valuables;
(*f*) Service as clearing agent, correspondent, etc., for other banks.

(vi) **Issuing Bank Notes.** In England this privilege is now restricted to the Bank of England. Before 1844 there were several note-issuing banks in this country, but, as will be shown later, the Bank Charter Act of that year strictly limited the issues, making provision for the ultimate abolition of all bank notes other than those of the Bank of England

Some details of the activities of the London Clearing Banks in recent years compared with the pre-war period are given in the table on p 214 The table on p 215 shows the extent of bank advances since 1951 and their distribution among the main industries and services.

Bank Loans

Bank loans are rarely made in cash A trader who borrows from a bank usually has the amount of the loan credited to his account Suppose he borrows £1,000. The bank normally demands securities for that amount, plus a certain proportion to allow for possible depreciation. The account books of the bank now show an increase in liabilities and assets Crediting the trader with £1,000 increases in effect the deposits (i e. the bank's liabilities), the liability of the customer to repay represents an increase in the bank's assets An expansion of bank loans is almost always accompanied by an expansion of bank deposits

It follows, therefore, that an increase in deposits does not necessarily denote a gain in aggregate wealth. Indeed, trade may be so sluggish that few attractive openings present themselves to would-be investors, who, until the opportunity occurs, prefer to leave their money on deposit with the bank Conversely a decline in deposits need not imply a falling off in total resources.

Two questions relating to bank loans call for consideration—

(1) *How is it possible for the bank to lend other people's money, perhaps for a long period, yet pay the claims made upon it on demand or at short notice?*

It is found from experience that, as a general rule, only a certain proportion (less than 10 per cent in this country) of the money deposited with the bank is required in cash at any one time. Many people use the bank simply to store their wealth and do not continuously withdraw it for business or other purposes. The banker works on a principle akin to the one governing insurance, i e. that individual uncertainties and peculiarities are levelled out in the aggregate. Banking is conducted on the assumption that at any time there will be a certain surplus of cash

LONDON CLEARING BANKS[1]

(Averages of Monthly Figures)
£ million

Year (Monthly Averages)	Total Deposits	Current Accounts	Deposit and Other Accounts	Coin, Notes and Balances with Bank of England	Balances with Other Banks	Money at Call and Short Notice	Bills Discounted	Investments	Advances to Customers and Other Accounts
1935	1,999	1,054	90	215	—	142	266	615	769
1936	2,216	1,197	982	228	—	165	320	643	865
1937	2,287	1,233	1,011	235	62	167	281	652	954
1938	2,277	1,244	1,033	241	60	151	280	637	976
1951	6,162	4,095	2,067	511	232	569	1,228	1,624	1,822
1952	6,083	3,961	2,122	505	226	529	1,062	1,983	1,838
1953	6,256	3,995	2,261	509	232	472	1,219	2,163	1,732
1954	6,495	4,141	2,354	528	256	457	1,206	2,321	1,804
1955	6,454	4,113	2,340	529	269	439	1,130	2,149	2,019
1956	6,288	3,994	2,294	516	275	431	1,270	1,978	1,897
1957	6,432	3,972	2,460	526	295	439	1,291	2,008	1,952
1958	6,636	3,840	2,796	543	306	434	1,277	2,149	2,007
1959 (Aug)	6,924	4,078	2,846	567	383	439	1,273	1,802	2,601

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[1] *Monthly Digest of Statistics*

BANK ADVANCES[1]

(Averages of Figures for Feb , May, Aug , and Nov)

£ million

MAIN ITEMS	1951	1952	1953	1954	1955	1956	1957	1958	1959 (Aug.)
Total	1,921	1,931	1,816	1,908	2,120	1,970	2,016	2,071	2,859
Personal and professional	434	402	367	374	389	332	324	341	544
Financial	207	183	185	206	228	214	234	220	370
Retail trade	207	189	170	177	193	173	166	182	269
Agriculture and fishing	190	199	200	214	234	225	227	229	302
Food, drink, and tobacco	143	158	132	134	162	156	151	156	171
Engineering, etc	109	150	154	138	159	197	233	236	295
Textiles	99	95	81	88	100	91	115	110	125
Local Government Authorities	92	78	78	89	91	81	83	79	93
Public utilities	75	96	87	120	163	94	57	66	80
Builders and contractors	71	66	61	61	72	69	64	67	126
Entertainment	28	25	22	21	21	20	20	21	27
Chemicals	26	35	26	27	31	33	32	33	38
Iron and steel, etc	17	31	55	49	30	40	56	50	69

[1] *Monthly Digest of Statistics*

deposited over cash required, and that this surplus can be loaned out at a profit.

(ii) *How much may the bank lend?*

The answer to this question is suggested by that to the first. In theory the banker need leave himself only just sufficient to pay the anticipated cash demands. In practice, of course, it is impossible to calculate with any precision what this amount should be, and the banker must necessarily allow a certain margin for safety. The liquid assets of the bank are so distributed that, in the event of unusual or even panic demands for cash, these assets can be quickly mobilized. Some bank loans carry a very low rate of interest on the express condition that they are repayable at call or at very short notice.

Amalgamation of Banks

The general tendency to concentration in industry and trade was reflected in a series of amalgamations in the banking world. In the first three decades of this century the number of banks fell from 106 to 28, though the number of branches increased from less than 4,000 to over 11,000 The "Big Five"[1] became predominant in British banking.

The advantages and drawbacks of amalgamation of banking firms resemble on the whole those of large-scale enterprise generally, but the following may be specially noted—

(i) *Advantages.*

(*a*) The organization tends to become more efficient and the many activities better co-ordinated.

(*b*) The reserves become more concentrated and thereby strengthened.

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[1] Viz Barclays, Lloyds, Midland, National Provincial, and Westminster Banks With the growth of Martins and the District Bank the number of "big" banks could now be put at seven

(*c*) Risks can be better distributed.

(*d*) Foreign connections and facilities for overseas trade become extended and improved.

(ii) *Drawbacks and Limitations.*

(*a*) The organization is liable, under certain conditions, to become too cumbersome.

(*b*) Interest in, and special knowledge of, local conditions may be reduced.

(*c*) The concentration of national resources in very few hands might tend to insecurity rather than strength

(*d*) Perhaps the most prevalent objection is the fear of a banking monopoly, the abuse of which would have serious economic and social consequences.

Such was felt to be the danger of a banking monopoly that in 1918 the Government set up a Committee which, after inquiry, recommended that, before further amalgamation could take place, the Treasury must make an investigation and give its sanction Though the proposed law was not formally enacted, subsequent schemes for amalgamation were in fact submitted first to the Treasury for its approval.

With the gradual strengthening of Government control over vital sections of the money market, and the nationalization in 1946 of the Bank of England which reinforced this control, the danger of private monopoly in banking was largely averted.

Section 2. Central Banks and the Bank of England

Central Banks and Monetary Policy

As was shown above, the focal position of a banking system is occupied by a central bank, which, in addition to its ordinary banking activities, co-operates with the government in giving effect to the monetary policy of the country. Thus, in the United Kingdom, there was a close relationship between the Bank of England and the Treasury long before the Bank was nationalized. In America, the Federal Reserve Board, which controls the twelve Federal Reserve Banks, collaborates with the United States Treasury.

The monetary policy of a country naturally depends on the prevailing economic conditions, internationally as well as at home. It may be directed towards maintaining stability of prices, and the central bank, with the backing of the government, may regulate money supplies accordingly. Or it may take the form of a more positive scheme to stimulate production in time of depression, actual or impending, or to curb activity when there is danger of over-trading and over-production.

The central bank is in a powerful position to give effect to such policies, for it usually has a monopoly of the right to issue notes, and is able to influence the working of the commercial banks, largely through the operation of its official discount rate as well as through open-market operations, which will be noted below.

The Bank of England

The functions and activities of the central bank in this country may be more closely examined, though much of what follows is now of historical interest only. Originally the right of issuing notes was possessed by a number of banks besides the Bank of England. In the years following the Napoleonic Wars, during which cash payments had been suspended, controversy arose respecting the proper method of note issue, and two conflicting schools of opinion emerged, the *Banking School* and the *Currency School.*

The Banking School. The members of this school contended that the amount of note issues should not be rigidly restricted by the gold reserve, but should be left to the discretion of the bankers. They maintained that, if the note issues were limited by the amount of gold backing, legitimate enterprise might be curtailed. It was further held that the note issues could be perfectly convertible even though the gold reserve fell short of 100 per cent.

The obvious criticism of the "Banking Theory" was that too much power and responsibility might be given to the bankers, whose interests might not always coincide with those of the community at large.

The Currency School. The advocates of the "Currency Theory" adhered to the principle of a full gold basis, and regarded a bank note merely as an economical substitute for gold rather than a pure credit instrument. Accordingly they recommended that the note issue should be strictly regulated by the amount of gold in hand.

The main criticisms of such a scheme were that the note issues might be too rigid and inelastic, and that difficulty might be encountered in the event of a temporary shortage of gold.

The members of the Currency School were more successful than their opponents in gaining the support of Parliament. Most of their recommendations were embodied in the Bank Charter Act of 1844, though the views of the Banking School were not entirely ignored

The Bank Charter Act of 1844

The following were the chief provisions of the Act of 1844—

(i) The Bank of England to have two separate departments, namely, the Issue Department and the Banking Department.

(ii) A fiduciary issue against Government Debt (£11,015,100) and other first-class securities to be permitted up to £14,000,000, all notes over this amount to be secured by an equivalent value of bullion.

(iii) Silver to be limited to one-fourth of the gold in reserve.

(iv) The Issue Department to pay notes for gold at £3 17s 9d. per ounce.

(v) The future issues of the existing banks to be limited to the average circulation for a short period preceding the Act.

(vi) No further note-issuing banks to be established and the existing banks to lose the right of issue in the event of bankruptcy, amalgamation, opening in the London area, etc.

(vii) On a country bank ceasing to issue notes, the Bank of England, by Order in Council, to have the power of increasing the fiduciary issue by two-thirds of the lapsed note issue.

(viii) A weekly return of the Issue and Banking Departments to be published.

(ix) The existing banks of issue also to furnish weekly returns.

Effects of the Bank Act on the Note Issue

(*a*) The Act secured full regulation and control of the paper currency, and publicity respecting the issues and reserves. The Bank of England came to have a monopoly of the right of note issue in England and Wales [1]

(*b*) The restriction of note issues tended for a time to limit credit facilities, though this difficulty was overcome by the increased use of cheques, the volume of which was not limited by any statutory bullion reserve.

(*c*) Notwithstanding the growth of the cheque system, the method of note issue was held to be too rigid and inelastic in the light of changing economic conditions.

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[1] The last other English bank to have these rights was Messrs Fox, Fowler & Co , which lost its privilege on amalgamation with Lloyds Bank in 1921 Certain banks in Scotland and N Ireland still issue notes

The Currency and Bank Notes Acts of 1928 and 1939

The Act of 1844 governed the entire note issue of this country until August, 1914, when, to meet the war emergency, the Treasury issued its own Currency Notes. The dual note issue continued in circulation until 1928, when it was decided to transfer the Currency note issue to the Bank of England, thus modifying the Act of 1844

The Currency and Bank Notes Act, 1928, fixed the new fiduciary limit at £260,000,000, but to provide for the varying needs of trade, it was made possible for the Treasury, on application from the Bank of England, to authorize an increase or a reduction in the fiduciary issue. The Act also laid down that the profits arising from the Issue Department should be paid to the Treasury, and the Bank was given powers to compel any person owning gold coin or bullion exceeding £10,000 in value to sell the whole or any portion to the Bank unless held for export or industrial purposes.

The Currency and Bank Notes Act, 1939, altered the normal limit of the fiduciary issue to £300,000,000, and introduced a new feature by providing for a weekly valuation of the gold and other assets in the Issue Department. The profits on the note issue received by the Treasury were to be paid into the Exchange Equalization Account.

The Bank of England Return

The table on p. 222 summarizes the weekly return of the Bank of England in both pre-war and recent years. The nationalization of the Bank of England did not result in any radical change in the form of the weekly statement.

BANK OF ENGLAND RETURNS[1]

AVERAGE OF WEDNESDAYS

£ million

	ISSUE DEPARTMENT			BANKING DEPARTMENT								
				Deposits				*Securities*				
	Notes in Circulation	Notes in Banking Dept	Government Securities	Total	Public	Bankers	Other Accounts	Total	Government	Discounts and Advances	Other	Reserve of Notes and Coin
1935	394·7	59·0	257·5	150·1	15·3	96·7	38·1	108·5	87·0	9·6	11·9	59·6
1936	431·4	52·9	254·8	151·4	16·7	96·2	38·5	115·7	88·8	9·8	17·1	53·7
1937	479·6	44·5	200·5	153·9	19·5	97·2	37·2	126·4	98·4	6·9	21·2	45·5
1938	485·6	43·9	202·7	160·7	18·2	106·2	36·2	133·7	103·2	9·6	21·0	44·9
1951	1,342·4	40·6	1,378·7	406·2	20·2	297·6	88·5	382·9	341·4	14·8	26·8	41·5
1952	1,435·2	40·7	1,472·2	376·7	25·6	277·2	73·9	352·7	314·8	15·5	22·3	42·2
1953	1,531·9	38·7	1,566·9	390·4	43·2	277·6	69·6	367·8	341·4	8·9	17·4	40·8
1954	1,630·3	32·1	1,658·5	368·8	20·6	281·1	67·2	352·5	327·4	9·4	15·7	34·5
1955	1,760·0	35·1	1,791·0	340·6	19·2	254·0	67·5	321·3	283·4	22·3	15·6	37·5
1956	1,875·1	36·4	1,907·3	317·5	16·1	228·0	73·3	297·2	257·8	22·7	16·8	38·4
1957	1,966·3	32·2	1,994·3	303·6	13·3	216·2	74·0	287·2	239·4	28·1	19·8	34·5
1958	2,034·6	33·7	2,064·2	303·0	12·6	217·9	72·6	285·5	245·4	19·7	20·4	35·6
1959 (Aug.)	2,165·8	34·5	2,196·8	296·9	12·5	220·3	64·1	279·9	243·6	13·6	22·7	35·4

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[1] *Monthly Digest of Statistics.*

Since September, 1939, the amount of gold coin and bullion in the Issue Department has been negligible, for almost the whole of it was transferred to the Treasury. The Reserve in the Banking Department, which is distinct from the gold reserve in the Issue Department, consists of notes from the latter Department, together with a small amount of coin and specie.

Until the early years of this century it was the policy of the Bank of England to maintain the Reserve at about 45–55 per cent of liabilities. Between 1914 and 1919 it fell from over 50 to under 10 per cent, but by 1929 it had recovered to its accustomed level. During the depression of the 'thirties it declined again, but this time, on recovery, it was not considered necessary to revert to the former high ratio. In the last few years it has averaged under 40 per cent.

Section 3. *The Money Market*

The Money Market

Conditions in the money market are more competitive than in the market for most other commodities, owing largely to the quickness of modern communication and to the ease of transferring credits from one place to another. The cost of this transfer, even where gold has to be sent, is comparatively small. The money market is ordinarily world wide, but events of late have materially impeded the flow of supplies from one country to another.

The sphere of operations of the money market in this country is in the vicinity of the Bank of England and Lombard Street. Besides the Bank of England and other banking institutions, together with the various discounting and accepting houses, the market includes brokers and jobbers inside and outside the Stock Exchange, dealers in foreign bills, underwriters, etc. All of these are concerned with the lending or borrowing of money, the lenders being chiefly the bankers, the borrowers mainly the bill brokers and other dealers.[1] The Treasury, too, is an important factor in the money market, and in recent years especially has taken a leading part on account of its large borrowings and the disbursements of dividends

Price of Money

While the *value* of money refers to its purchasing power, the *price* of money in the City means the rate that is charged for its use Like the price of anything else, it is determined by conditions of supply and demand. When money is plentiful the rate of interest or discount tends to be low; when money is scarce the rate tends to be high.

Interest is the price that is paid for the use of money, and varies with the quantity of funds available for investment in relation to general market requirements, with the nature of the particular loan, and also with the length of the period for which the loan is required

Discount is the price that is paid in order to obtain immediate realization of a bill or other claim for value which is not yet due for payment by the original acceptor.

The two rates are interdependent, and over a period, there cannot be any appreciable difference between them. Suppose, for example, that the average rate of interest is 3 per cent, and that the rate of discount is 2 per cent, and that all other things are equal. It will clearly be more remunerative to put money into interest-bearing

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[1] *Discount Houses* are those institutions that specialize in the discounting of bills They are of service to dealers who are not prepared or able to wait until the bills mature, but require ready cash

Accepting Houses accept responsibility for bills on behalf of traders whose names alone may not be sufficient to obtain the desired credit, They are necessary in international trade particularly, in that a creditor, who is unacquainted with a customer in another country, will unhesitatingly receive a bill which has been accepted on the debtor's behalf by an accepting house of international repute

Though a few firms still specialize in discounting or accepting services, most of this business is now performed by the banks investments than into the bill-discounting market. Consequently there will tend to be a transfer of money to ordinary investment, causing a fall in the rate of interest, while the reduction in money supplies for the discount market will tend to bring about a rise in the discount rate.

The period of a loan is an important factor in determining the rate of interest For reasons of safety a bank has to keep a fairly large proportion of its assets as "liquid" as possible, to meet any unusual demand for cash; for it to have too much of its resources in a "frozen" form is liable to be dangerous On the other hand, it wishes to keep the amount of idle money to the minimum. The bank, therefore, lends out a certain part of its funds to brokers and others, which can be reclaimed "at call or short notice" The "Call Rate" charged for such loans is necessarily lower than the ordinary rate.[1]

Effects of Movements in the Bank Rate

The Bank of England Rate is a discount rate, i e the minimum at which the Bank will advance money on first-class bills In 1938 it was 2 per cent and, apart from a temporary increase in 1939, remained at that level until 1951, when it rose to 2½ per cent. In the following years, in conjunction with other measures to curb borrowing and check inflation, the rate was increased, reaching 5½ per cent in 1956. Early in 1957 it was reduced to 5 per cent, but in the autumn, as a crisis measure, was raised to 7 per cent. In 1958 it was lowered in stages to 4 per cent and was unaltered until January, 1960, when it was raised to 5 per cent

The sequence of events ordinarily following a change in the rate may be briefly outlined—

(1) A rise in the Bank Rate is usually followed by an

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[1] In recent years the Treasury has been the principal borrower in the short-term market The chief lenders have been the banks, as this type of transaction is unsuitable for the ordinary investor.

increase in the rate of discount of the joint-stock banks and financial houses. Would-be borrowers from the Bank of England try to get cheaper accommodation from the other banks, who, partly to secure their own reserves, partly to make a profit, raise their charges, though not necessarily to the same extent.

If, however, the market conditions are such that the market rate does not automatically rise with the Bank Rate, the Bank of England may make its rate effective by selling Consols and similar stock, and also by borrowing in the open market. By such means the balances at the joint-stock banks are reduced, and the market rate is brought into line with the Bank Rate

(ii) In consequence dealers and bill holders may be less willing to borrow money or to discount bills

(iii) Since money commands a high rate in the discount market, foreigners may be induced to transfer credits to this country (provided that free conditions obtain). They may also be willing to extend the credit facilities they have already given

(iv) For the same reason stocks and shares may be sold in order to transfer the proceeds to the more profitable discount market. The prices of securities in the investment market are thus liable to fall.

(v) Traders who find it too expensive to borrow money at the high rate may prefer to dispose of their stocks at reduced prices

(vi) Since a rise in the discount rate is usually followed by a rise in the deposit rate of interest, bank deposits may increase, thereby reducing the immediate demand for commodities, and reinforcing the tendency for prices to fall.

(vii) A fall in prices, if not accompanied by a similar decline in other countries, may, in the absence of restrictions on the flow of commerce, lead to increased exports and to diminished imports. Foreign indebtedness may thus be reduced and the drain on the Reserve eased Also, for reasons discussed in a later chapter, it may cause the foreign exchanges to become more favourable.

(viii) *The general result, therefore, of raising the Bank Rate is to diminish the demand for money, and to increase the supply.* Ultimately the situation may warrant a downward revision of the rate.

The events following a reduction in the Bank Rate follow roughly the same pattern in reverse, and need not be set out in detail

Qualifying Conditions

(*a*) Raising the Bank Rate is followed by a rise in the market rate only if the demand for money is keen. If money is not in great demand the other banks, despite the special devices of the Bank of England for influencing the market, will not necessarily raise their rates, as customers and therefore profits may be lost in consequence. A fall in the Bank Rate, on the contrary, must inevitably be followed by a fall in the market rate, if the banks wish to retain their custom.

(*b*) With the growing identification of the Bank of England with the Treasury, culminating in its nationalization, the power of the Bank Rate as an independent factor has on the whole diminished The rate of interest paid on Treasury Bills has become a major influence, while the Bank Rate now tends to be as much an index of market conditions as a determining element in itself[1]

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[1] According to the Report of the Radcliffe Committee on the Working of the Monetary System (para 441), "the rise in Bank Rate is symbolical it is evidence that the United Kingdom authorities have the determination to take unpleasant steps to check inflation" See below, p 342 n

Open Market Operations

One of the functions of the Bank of England has for long been to act as guardian of the credit system. With the nationalization of the Bank this guardianship is more than ever its responsibility. It is the principal agency for controlling the quantity of credit created by the banking system so that any tendencies of an inflationary or a deflationary character may be guided and kept in check. The Bank of England effects this control through its "Open Market Operations," whereby it enters the open market as either buyer or seller of Government securities. These operations may be briefly illustrated.

Suppose that conditions are such that the Bank feels that some restriction on credit is necessary. Possibly there has been a wave of speculative buying on the Stock Exchange The Bank's agents may then come into the market and sell securities, say, £100,000 worth. The buyers of the securities will pay for them with cheques drawn on their accounts with the commercial banks, whose reserves will in consequence be reduced by £100,000. Finding that the proportion between their reserves and loans will have changed, and in order to restore equilibrium, these banks will now call in some loans. If the proportion between loans and reserves is ten to one, £1,000,000 will have to be called in by these means.

If, however, there is a shortage of credit and the Bank of England considers that the commercial banks are unable or unwilling to grant sufficient loans, it may enter the market as a buyer of securities. The effect of this would be to expand the reserves of the commercial banks and to increase their lending powers.

The Bank of England can, therefore, by a judicious combination of changes in the Bank Rate and open market operations exert a considerable influence on the money market.

The Capital Market

The market for capital investment, as distinct from credit loans, has a two-fold structure and organization—

(i) **The Market for New Capital Seeking Investment.** Here the principal agencies are a comparatively small number of issuing houses and finance companies. On the Continent and in America the commercial banks directly provide industry with much of its capital, but British banks normally prefer not to lock up their funds in long-term investment [1]

(ii) **The Market for Invested Capital.** This market is in the main provided by the Stock Exchange, where invested capital, in the form of stocks and shares, is bought and sold. The Stock Exchange is not expressly designed as a market for new capital, but by its very existence, and the standards and conditions which it prescribes, it exercises a profound influence on capital supplies [2]

The members of the London Stock Exchange consist of stock-brokers and stock-jobbers. *Brokers* rarely act as principals, but serve rather as intermediaries between the jobbers and the public. They make their profit on the commission, and rarely carry any appreciable amount of stock on their own account. In addition, there are outside brokers who effect their dealings through inside members

Jobbers are usually specialists in particular branches of the stock and share market, and deal on their own account. They make their profits not from commissions, but from the difference between their buying and selling prices. A jobber, on being asked by a broker for a quotation, normally states two prices, the lower one for buying, the higher one for selling The margin, known as the "jobber's turn," is usually narrower in dealings in gilt-edged or first-class industrial securities than in markets where trading is less free and active.[1]

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[1] See also p 319 n

[2] Besides the London Stock Exchange there are twenty provincial exchanges

Classes of Investors

The market for securities is divided into certain sections, such as those dealing in Government Stocks, Industrials, etc. The stocks and shares themselves are widely differentiated, catering for all types of investors—

(*a*) Those who seek in the main a definite and assured income from their capital and, because of the comparative safety, are satisfied with a modest return.

(*b*) Those who aim at a relatively high immediate return, in consideration of which they are prepared to undertake a commensurate degree of risk.

(*c*) Those who are not so much concerned with income as with long-term appreciation in capital values (especially where such appreciation is not liable to tax)

(*d*) Those who have no desire to remain in permanent possession of the securities, but buy primarily in order to sell again, if they can, at a higher price.[2]

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[1] *Contango* brokers are those who lend to other brokers who need money for settlement of accounts Instead of advancing a loan in the ordinary way, they act as pawnbrokers for shares For a consideration, they "carry over" the shares in question until the next settlement day

Backwardation is the opposite of "contango " If a broker has guaranteed delivery of certain shares, but cannot obtain them for the time specified, he may borrow those shares from somebody who happens to have them, depositing an equivalent sum of money as security, to be returned when the shares are paid back

Option dealings, which enable dealers, on payment of a suitable premium, to buy or sell at a given future date and at a pre-determined price, were suspended in 1939 and not re-introduced until 1958

[2] Many in the last category come within the category of speculators rather than investors In stock-market terminology those who apply for shares when first issued with the intention of selling them very soon are known as "stags " "Bulls" are dealers who buy for a rise, in the hope that the eventual price will yield them a profit "Bears" are those who sell for a fall, in the hope that before the delivery date they will be able to acquire the securities at less than the price first contracted

Types of Securities

To meet the requirements of the several classes of investors a wide range of securities has been devised. These may for convenience be divided into securities with fixed and variable payments, though the line between them, and between their sub-divisions, is not always rigid.

(i) *Fixed Dividend Securities*

(*a*) *Public Loan Stocks.* Most government and municipal issues, as well as those of public boards, come in this category. The investor merely lends his capital, he has no share in management. Securities of this kind are normally redeemable by or before prescribed dates, and the borrower usually creates a sinking fund for this purpose. There are, however, various "perpetual" stocks which the borrower need not redeem except at his option.

(*b*) *Debentures, Mortgage Bonds, etc.* Companies and other bodies frequently obtain loan capital in these forms. Specific assets may be earmarked for realization should the interest not be forthcoming, and provision is usually made for the appointment of a receiver should the payments fall seriously into arrears.

(*c*) *Preference Shares* Though there is a certain resemblance between these and debentures, the preference shareholder, different from the debenture holder, is not a creditor of the issuing body but is a part proprietor. He is entitled to a fixed dividend after the prior charges, if any, have been met, though sometimes there is provision for an additional "participating" payment after the ordinary shareholders have been assured of a specified minimum reward. Preference shares are often cumulative, whereby any unpaid dividends are carried forward as a liability to the company and must be paid in an ensuing period before any dividend can be made to the ordinary shareholders.

(ii) *Variable Dividend Securities*

(*a*) *Ordinary Shares.* These holdings normally constitute the "equity" of a company They confer on the owner the right to all profits (and assets in the event of winding-up) after the claims of debenture and preference shareholders have been met.

(*b*) *Deferred Shares.* Dividend on these shares, where they exist, is not paid until the previous classes have received a minimum return. In such circumstances any ordinary shares come partly within the preference class, the true equity being vested in the deferred shares.[1]

Risk-bearing and Speculation

The term "speculation" embraces dealings ranging from investment in anything less safe than gilt-edged securities to engagement in highly risky ventures. It applies to transactions in the commodity markets as well as to those in stocks and shares

One of the most important functions of the entrepreneur is to anticipate the market demand and initiate supply in order to meet it. In this form of enterprise an element of speculation is unavoidable Similarly, dealers may foresee a shortage of a particular commodity, and increase their present purchases. The ensuing rise in price may so discourage consumption and stimulate production that actual supplies turn out to be more plentiful than had been reckoned.

Or it may happen that, in the expectation of a glut and a consequent fall in prices, dealers may unload their current stocks, with the intention of replenishing them later when prices are lower. This may cause a modest fall in prices in the present, an increase in consumption and a contraction in production By the time new supplies arrive, existing stocks may be so run down that the total quantity on the market is not as plentiful, and prices not so low, as had been expected.

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[1] Individual investors, especially those with limited funds, can spread their risks over a wide field through the agency of investment trusts "Open" trusts, the older type, are constituted as limited companies, they issue their own stocks and shares, and distribute dividends from the proceeds of their investment operations "Fixed" or "unit" trusts are not so incorporated, they acquire holdings in a number of concerns so as to form units, and these are divided into sub-units which are sold to the public In recent years there has been a market growth in the number and scope of unit trusts, catering largely for the small and medium investor

In so far as they help to regulate production and consumption, and smooth out market fluctuations, operations of this character render a positive service. This cannot be said, however, of all transactions based on estimates of the future. Operations of this kind, to be successful, usually require special skill and experience and ample capital and credit. Where speculators enter the field with insufficient knowledge and resources they may not only lose their own money but inflict heavy losses on others

Insurance

While risk-bearing is still an important feature of the economic system, the burden of individual risks has been lightened to some extent by the development of insurance. The principle of insurance is to spread the risk of loss over a large number of persons or firms, who each ordinarily contribute an appropriate amount to a central fund. It is known from experience that over a period a more or less determinable proportion of the contributors suffer from the contingency insured against, and the premiums are calculated so as to provide an adequate fund.

Some types of risk lend themselves better to insurance than others. Thus the liability to loss by fire, theft, accident at sea, etc , has for long been covered by insurance schemes. More recently schemes have been evolved for insuring against loss of profits, e.g. following a fire, as distinct from the capital loss of the property itself. This kind of insurance is known as "consequential loss" insurance. One can even insure, under a "pluvius" policy, against losses caused by rain. In addition there has evolved in recent years a network of social insurance schemes, most of which (such as unemployment and sickness insurance) are administered by the State, though a large volume (such as life assurance) remains on a voluntary basis.

All insurance schemes do not necessarily follow the above pattern. A large firm with vast resources may find it more economical to carry its own insurance For example, a shipping line may set aside a portion of its income annually to provide against loss at sea, in effect it pays a premium on each ship into its own fund, which is drawn upon when the contingency arises. Or, as in some branches of social insurance, specific premiums may be dispensed with. The cost, for instance, of providing non-contributory pensions is calculated in the public actuary's department and provided from general tax revenue

CHAPTER XV

INTERNATIONAL TRADE

Section 1. *The Theory of International Trade*

Differences Between Home and International Trade

THOUGH the fundamental principles governing international and home trade are similar there are certain practical distinctions to be noted. These differences, however, are not as might at first be supposed, attributable to greater expenses of transport. The cost of carriage between Dover and Calais, for instance, is much less than that between Dover and Dundee. But where goods have to pass over a national boundary, some special problems arise and a distinctive machinery of exchange has to be employed.

An important difference between home and foreign trade is to be found in the immobility of labour and, to a smaller extent, of capital. The flow of labour at home is relatively free compared with that between two countries. Despite the possibility of economic gain if he goes abroad, a man ordinarily prefers to stay at home, by reason of family ties, patriotism, language difficulties, or simply inertia. In recent years the tightening of immigration laws and other regulations has further restricted population movements.

While capital is not subject to the same personal preferences as labour and is therefore not so immobile, it tends as a rule to be invested at home rather than abroad, unless the net earnings expected on foreign investments are appreciably greater than those to be obtained in the home country.

Exports Pay for Imports

In the early days of foreign trade, imports were paid for very often in gold and silver. Such a method to-day would be impracticable, because—

(*a*) The world's stocks of specie, even if they were available for money, would be insufficient to cope with the aggregate volume of business

(*b*) Transport of specie entails undue expense and risk.

(*c*) The precious metals would be diverted from internal use in the arts, and, if the country still used them as circulating money, from the currency system as well.

It is in the general interest, therefore, to reduce the payments in specie to the minimum. By an indirect process all the exports of a country are, in effect, set against all the imports. Only the differences between the aggregate values need be paid in coin or bullion. By means of the modern credit system trade to the value of thousands of millions sterling takes place annually with very little recourse to the transmission of gold.

Barter is at the basis of all exchange, but is especially evident in international trade. British imports of food and raw materials, and exports of manufactured goods, are reckoned in terms of money, but, as will be explained in the next chapter, the transactions, taken as a whole, are largely effected by mutual cancellation of debts. Where ordinary credit facilities are not available resort may be made to direct barter. In recent years, owing to shortage of foreign currency or to other reasons, many countries have been compelled, or have found it expedient, to engage in such transactions

The Balance of Trade and Balance of Payments

By a country's *Balance of Trade* is meant the difference between the value of its exports over a period and the value of its imports. Included in the exports and imports are the "invisible" items such as shipping, insurance, and financial services. The balance is said to be positive or "favourable" (a relic of mercantilist terminology[1]) if there is an excess of exports, negative or "unfavourable" if there is an excess of imports. A country's balance of trade need not, and rarely does, balance in fact.[2]

The *Balance of Payments* consists of a "balanced" statement in the ordinary sense. On the one side of the account is the value of a country's commodity exports, gold exports, shipping, insurance and financial services, expenditure in the country by foreign tourists, gifts from abroad, etc. On the other side of the statement is the value of a country's visible and invisible imports, interest payments to other countries, gifts to other countries, expenditure by tourists abroad, etc.[3]

The Law of Comparative Costs

Foreign trade is based on an international division of labour. Each country tends, so far as trade is unfettered and production is not artificially regulated (a proviso which is not in fact fulfilled), to specialize in the production of those commodities for which it is best fitted. It will not necessarily specialize, however, in those commodities which it can produce at a lower *absolute* cost than elsewhere; rather it will tend to supply those things in the production of which it has a *relative* advantage over another country. This tendency is usually known as the Law of Comparative Costs, which, as applied to international trade, states that under competitive conditions a country tends to specialize in those commodities in the production of which it has the greatest comparative advantage.

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[1] See pp 241 and 355

[2] The United Kingdom enjoyed a positive balance of trade prior to 1931, but the depression in that year resulted for a while in an unfavourable balance The improvement in the late 'thirties was upset by the outbreak of the war For particulars of Britain's exports and imports, and changes in the balance of payments, see Chapter XXII

[3] If the prices paid for a country's imports have risen in greater degree than those received for her exports, the *terms of trade* are said to have gone against her

The law of comparative costs may be illustrated by some hypothetical examples. For simplicity the expenses of transport are not considered, though in practice, of course, they are an important item in the total cost of production Perfect freedom of trade (a circumstance all too rare nowadays) is also assumed.

(i) Suppose there are only two countries, A and B:

A	B
Can produce wheat at £1 per bushel and cloth at 10s per yard	Can produce wheat at £2 per bushel and cloth at £1 per yard

Under such conditions, A, being the cheaper country for both commodities, will export wheat and cloth to B, which will send money in return. Therefore, in accordance with the Quantity Theory, prices will tend to rise in A and fall in B until the respective costs of production are equal in A and B—say 30s. for wheat and 15s. for cloth. Beyond this point there is no advantage in continued exchange. In both countries the relative costs are in the ratio of 2 to 1. Neither country has a permanent advantage in relative costs, and, therefore, permanent trading is not warranted.

(ii) Suppose, now, that A and B have different *relative* costs of production—

A	B
Can produce wheat at £1 per bushel and cloth at 10s per yard	Can produce wheat at £3 per bushel and cloth at £1 per yard

Again, A has an advantage in both commodities, and will export wheat and cloth to B until, for the monetary reasons stated above, costs rise in A and fall in B. The time may arrive when wheat costs 30s. in A and £2 5s. in B, while cloth costs 16s in both countries. A point of indifference respecting cloth is reached, but wheat will still be exported from, and money flow into, A, until the cost of cloth may conceivably be 17s in A and 15s. in B Permanent trade, therefore, is possible, A specializing in wheat and B in cloth.

Another way of demonstrating the advantage of international trade is to examine the total costs of production for the two countries together, before and after specialization A simple calculation shows that the aggregate costs for the two countries would be appreciably greater in the absence of territorial specialization and exchange. The illustration may also be adapted to any number of countries with the same general result

From the doctrine of relative costs it follows that *it may be advantageous to a country to import a commodity from another, even though she can produce it herself more cheaply,* provided that her resources are being applied to the production of other commodities for which she is relatively better suited To produce every type of commodity herself might result in a less economical disposition of her resources and a smaller total output than if she concentrated on those articles for the production of which she was best fitted, even if that meant her importing goods that could be produced at home at apparently less cost.

Although the law of comparative costs has been formulated here with special reference to international trade, it applies no less to other forms of economic activity, and is indeed but a special application of the principle of division of labour. Though a business man might be able to do clerical work better than a hired clerk, it is to the general advantage that he should not engage in this less productive work, but should devote his full energies to the higher functions of business which render greater returns Similarly, a stores manager might be a better salesman than a man at the counter, but it is preferable that he should give his whole time to work of the higher order

The **advantages of foreign trade** are no different in principle from those accruing to internal exchange, but, on account of the larger territory usually covered, certain of the benefits are more pronounced—

(i) Each country under free conditions tends to produce those commodities for which it is naturally suitable.

(ii) Where supply and demand are spread over a large area, prices tend to be more stable and uniform.

(iii) Products are available in greater variety.

(iv) Local shortages do not cause as much inconvenience if supplies can be obtained from elsewhere.

Since in time of war, and also during periods of tension, the above advantages are lost or diminished, the mutuality of trade relations and the recognition of economic interdependence should be powerful forces making for international peace.

Section 2. Protection and Free Trade

Early Restrictions on Foreign Trade

In former times it was considered to be against the national interest to import goods from other countries. As it was impossible, clearly, to engage in exports without accepting imports in exchange, the early *Bullionists* stipulated that, as far as possible, only gold and silver should enter the country, these being regarded as the staple forms of wealth. During the fifteenth and sixteenth centuries various measures were adopted to encourage the export of goods and the import of specie, while the export of specie and the import of goods were looked upon with disfavour.

When it became recognized, about the time of the Tudors, that there were certain foreign goods, apart from specie, that a country must import, the bullionist doctrine was modified by the *Mercantilists* so as to allow of the importation of these wares, provided that the total value of imports was less than that of exports, with a consequent inflow of gold and silver to pay for the difference To ensure a "favourable" balance of trade, however, measures were adopted to restrict the importation of such goods as could be produced at home Protective duties, bounties and other forms of preferential treatment were all part of the mercantilist plan

One result of the continual inflow of gold and silver was that prices ever tended to rise. This had the effect of discouraging overseas buyers and of encouraging people at home to increase their purchases abroad. Such a situation naturally conflicted with the prevailing policy.

In the eighteenth and nineteenth centuries the dependence on foreign materials and foodstuffs increased, and the demand for the removal of restrictive duties gradually became insistent The policy of free trade found favour among manufacturers and economists in this country, though rival nations, who were less dependent on international trade, were not so readily attracted to the doctrine

In 1846 the tax on imported corn was repealed, and in subsequent years the majority of the duties on raw materials and manufactured goods were also abolished. By the end of the century less than a score of goods were liable to import duties, the object of which was revenue rather than protection. Free Trade remained the accepted policy of this country until in recent times, when her altered circumstances in relation to the rest of the world necessitated some modification in fiscal methods.

The Revival of Protectionism

Developments abroad served to accentuate the change in Britain's relative position. Countries that had formerly bought her goods were now producing them within their own territories, often behind the shelter of a tariff wall. Manufactures were coming into this country in increasing amounts, produced under conditions of cost with which British factories could not always effectively compete. Thus, a demand for protection gradually revived, though it was not until the first world war and the succeeding years that free trade was seriously undermined The "McKenna" and "Safeguarding" Acts were the heralds of the new protectionism, which was subsequently extended by Imperial preference and other measures.

Though tariffs are the customary method of securing protection, sundry other devices are employed. For certain purposes *Subsidies* may be preferable They may be more direct and certain in their effects, they may encourage exports; and they may not restrict international trade in the same way as import duties Different from tariffs, however, they do not furnish revenue, which, though liable to vary inversely with the degree of effective protection, is acceptable to the Chancellor.

Though *Import Boards* have usually other and more legitimate purposes, they may be utilized in such a way as to have a protectionist effect. Similarly a system of *Licences* may be employed. Finally may be mentioned the *Quota System*, which requires a minimum quantity or proportion of a given class of goods to be produced at home. This method has been used, for instance, with the object of fostering the British film industry.

Protectionist Arguments and Criticisms

The chief protectionist arguments and the respective criticisms are tabulated in the following pages

Arguments for Protection	Criticism
(i) *That essential industries need protection.* In these are commonly included agriculture, and also those industries supplying military and naval needs. Entire dependence on foreigners for these commodities might cause serious difficulty in time of war.	(i) It is sometimes difficult to decide whether, and to what extent, one industry is more essential than another. And protection of such industries might prove to be detrimental to the consumers of their products.
(ii) *That "infant" industries need protection.* It is claimed that a new industry, if protected during its infancy, will grow strong enough eventually to dispense with the need for protection.	(ii) An "infant" industry is not always easy to define. A protected "infant" industry may be unwilling ever to admit itself "grown up," for fear that the protection be removed.
(iii) *That protected industries benefit from increased output and diminished costs.* A popular argument, in some ways allied to (ii), is that the greater market assured to the protected industries permits of a larger production, and a reduction rather than an increase in prices.	(iii) Protection may increase the total *volume* of production in an industry, but need not increase the *scale* of production. The tariff may conceivably cause the number of small firms to increase, and the average size of the units or the scale of operation to diminish. It may subsidize the inefficient, which, but for the duty, would be driven out. The unit costs for the industry as a whole, therefore, may be even higher under protection than under free trade.
(iv) *That costs of production should be equalized.* Some tariff advocates urge that duties should be imposed of such dimensions as to offset the lower production costs of foreign competitors.	(iv) The argument for equalizing costs can readily be shown to be unsound. All the advantages of international specialization would disappear. If the principle were logically applied, the duties would have to be differentiated according to varying costs in each of the several countries. This would hardly be practicable.

Arguments for Protection	Criticism
(v) *That protection means high wages* It is argued that an industry which is not undercut by foreign rivals can pay its workers better wages	(v) Even if the workers in a protected industry were to receive higher money wages, their real income might be discounted to some extent by the increase in prices And any benefit to them might conceivably be at the expense of the workers in non-protected industries
(vi) *That unemployment is reduced* It is maintained that the diversion of demand to home-produced goods must necessarily reduce the volume of unemployment Further, to the extent that the foreigner opens factories in the countries imposing the tariff, in order to avoid paying the duty, more employment is provided for the home population	(vi) Unemployment may be reduced in the industry directly protected, but, as with the higher wages argument, one must regard the effects on industry as a whole If imports are cut down, exports are liable to follow suit —with consequent unemployment in the export trades
(vii) *That protection is necessary to guard against "dumping"* A firm abroad that enjoys monopolistic or other advantage may charge comparatively high prices in its own country, but, wishing to secure the advantages of large-scale production, may produce more than is absorbed by the home market The surplus may be "dumped" elsewhere at abnormally low prices Similarly, a government may subsidize home producers in one way or another in order that they may sell abroad and obtain foreign currency.	(vii) Where a foreign producer deliberately sells under cost in another country in order to crush competition, with the intention of raising the price as soon as his rivals have disappeared, or where he is subsidized by his government and can undercut therefore his rivals abroad, little objection can be raised to the adoption of preventive measures Such "dumping," however, is often temporary and spasmodic in nature
(viii) *That there should be a great diversity of industries* Under free trade, the protectionist argues, a country may specialize in very few staple	(viii) It is not true that a country under free trade concentrates on very few industries The variety among the industries of the United Kingdom under

Arguments for Protection	Criticism
industries, the failure of any of which might cause especially severe hardship Where there is a great variety of industries, the danger is not so great	free trade, for example, left little to be desired
(ix) *That the balance of trade is improved* Imports are discouraged by protective duties, with a corresponding improvement in the ratio of exports	(ix) The decline in the favourable balance of trade in recent years has been due not so much to the increase in imports as to the falling-off in exports, particularly those of the invisible kind, such as the services of shipping and foreign investments
(x) *That the foreigner may pay the duty*	(x) It is not true that the foreigner can be made to pay the duty, except in a few isolated instances [1] If he did pay the tax and sold his goods as before, there would not be much protection afforded to the industry If he added the cost to the price, the consumer would suffer It would seem, therefore, that if the home producer benefits at all, it must be at the expense, not of the foreigner, but of the home consumer

The Case for Free Trade

The case for free trade, which has to some extent been presented indirectly in the criticism of protection, may be restated more positively.

(1) The resources of a country, both human and material, should be allowed to flow freely into those channels where they can be most economically employed, i e. into those industries that offer the greatest relative advantage. If a country is permitted to specialize in the production of

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[1] See below, pp 284–6, on the incidence of Customs duties

those commodities for which it is by nature and situation most suitable, the national dividend is likely to be greater than under an artificially regulated system.

(ii) Free trade has the merit that it stimulates home producers to put forth their best efforts and keep abreast of new forms of technique.

(iii) From the point of view of the consumer, free trade is preferable, not only because it usually means lower prices, but also because it affords a wider range of choice, and does not interfere with his liberty to buy such commodities as he chooses.

(iv) Free trade offers less opportunity for the creation of vested interests and the rise of pressure groups.

It is true that, with the emergence of nationalism and the spread of authoritarian control, these considerations have lost some of their force. Even where, as in Britain, there has been a long tradition of economic freedom, it has been considered necessary in the general interests to impose some considerable restraints on trade. Before 1939 this country had entered upon a number of bilateral agreements. Since the war she has been driven to depart even further from the open-door policy.

Though prevailing conditions make an early return to general free trade unlikely, promising schemes have lately been adopted to widen the areas within which nations may engage in commerce on a more liberal basis. Reciprocal schemes between members of the British Commonwealth have brought useful results As a result of the General Agreement on Tariffs and Trade (GATT), initiated by the United Nations, some progress has been made in reducing or at least stabilizing thousands of tariffs over a wide range The experience of the Benelux system has demonstrated the practicability of harmonizing trade relationships among some of the smaller European countries.

Steps have been taken recently to form a European Common Market, though so far with only limited success. In 1959 a group of six countries, led by France and W. Germany, entered upon a mutual scheme for a reduction of tariffs. A second group of seven countries, including Britain and Sweden, was formed soon afterwards with similar reciprocal benefits in view. It was hoped that from these loosely-knit associations a more comprehensive and better integrated union might eventually emerge.

CHAPTER XVI

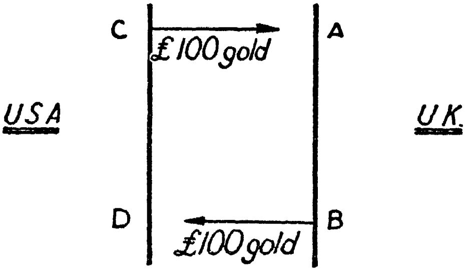
THE FOREIGN EXCHANGES

Section 1. The Method of Foreign Exchange

The Importance of Credit in Foreign Trade

IN its early days foreign trade was carried out either by direct barter or by payment in the precious metals. The former method was very clumsy, and suffered from the drawbacks inherent in direct exchange. The latter method, though an improvement, was still highly inconvenient and wasteful The risk of loss, too, was considerable. In the same way as credit largely supplanted cash payments in internal trade, it come eventually to be adopted in international transactions

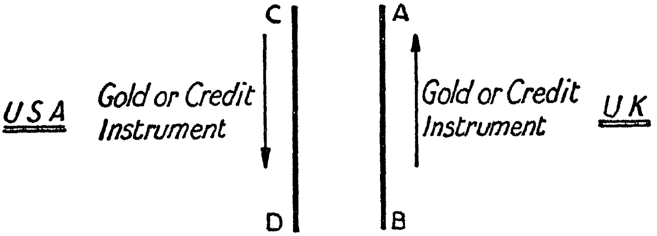
The credit system enables *debits and credits near together to settle obligations far apart.* The following simple examples illustrate this operation—



(i) Suppose that A in the United Kingdom has a claim on C in the United States for £100, and that D in the United States has a claim on B in U.K. for an equal sum. The debts *might* be settled by direct payment in gold, C to

A and B to D. This method, however, would be cumbersome, expensive, and risky.

(ii) Suppose now that an arrangement is reached by which the debit and credit on each side of the Atlantic are made to settle each other. Thus, B is put in touch with A, and pays him a sum in exchange for the latter's claim on C; B then sends this claim in settlement of his own account to D, who finally presents it to C and receives the money.



Even if this method involves the payment of gold it is still superior to the other, in that the costs and risk of transport are reduced.

(iii) But if the system is further developed, and the payments are effected by credit instruments, the gains are even more considerable Under ordinary conditions the amount of bullion employed in international trade is a very small proportion of the total volume of business.

The Bill of Exchange

Though the nature and functions of the bill of exchange may best be considered in connection with foreign payments, its place in domestic trade should not be disregarded Indeed, the ordinary cheque, which is the principal form of credit instrument in home transactions, is essentially a bill of exchange, drawn upon a banker and payable on demand.

The bill of exchange is generally defined as "an unconditional order in writing addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand, or at a fixed or determinable future time, a sum certain in money to, or to the order of, a specified person or to bearer."[1]

A bill of exchange is known as a "trade" bill when it is based on a transaction in actual goods. It is known as a "finance" bill when it is drawn against the credit of the acceptor rather than against some specific or tangible form of wealth. A finance bill need not be any less substantial than a trade bill, and, when issued or backed by an organization of high standing, may rank as a first-class security.

Functions of the Bill of Exchange

The bill of exchange serves a number of purposes—

(i) *A form of currency.* A bill of exchange, particularly in international dealings, may change hands several times, and thus facilitate exchange hardly less effectively than ordinary currency.

(ii) *A means of investment.* Bankers and others find in high-class bills of exchange a useful form of investment, whether they keep them until the date of maturity or sell them before that date. The fact that bills are selfliquidating makes them specially attractive to bankers, who do not wish to tie up their resources for lengthy periods, and who so arrange their purchases as to provide a fairly regular supply of liquid money.

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[1] The following is a simple form of Foreign Bill.

£1,000 *London,*
Stamp *15th September,* 19..
10*s*

Three months after sight pay this First of Exchange (second and third of even tenor and date unpaid) to *P Q* or order the sum of *One Thousand Pounds* for value received.

T V & Co

To *R S,*
New York

T V & Co are the creditors in London who draw the bill on R S in New York, making it payable to P Q or order The bill is accepted by R S writing his signature and date of acceptance across the face of it, or an accepting house doing it on his behalf.

(iii) *A means of obtaining ready cash.* A seller may be unable to wait for some weeks or months until the buyer is in a position to pay. By drawing a bill, which is "accepted"[1] by or on behalf of the buyer, and then discounting it with a bank or other agency, the seller is able to obtain ready money, equal in amount to the face value of the bill less the appropriate discount.

The Bill Broker

Under ordinary trading conditions there are large quantities of bills in the market. Traders who possess bills due to mature at a future date may need money immediately and wish to find buyers on the most advantageous terms. Banks and investors, on the other hand, are prepared to purchase suitable bills at favourable prices, while there are also debtors who are seeking bills to transmit them to their creditors abroad.

Buyers and sellers are commonly brought together, in effect, by bill brokers, of whom there is more than one kind. The smallest class comprises the "running brokers" who serve as intermediaries, and are in close touch with the banks, ascertaining what bills are for sale and what are in demand. They work principally on commission, and require, therefore, comparatively little capital Secondly, there are the brokers who act as principals, and depend for much of their working capital on bank loans, which are granted for short periods at specially low rates. Thirdly, there are the discount houses, already mentioned, which are responsible for much of the bill-broking business in the City.

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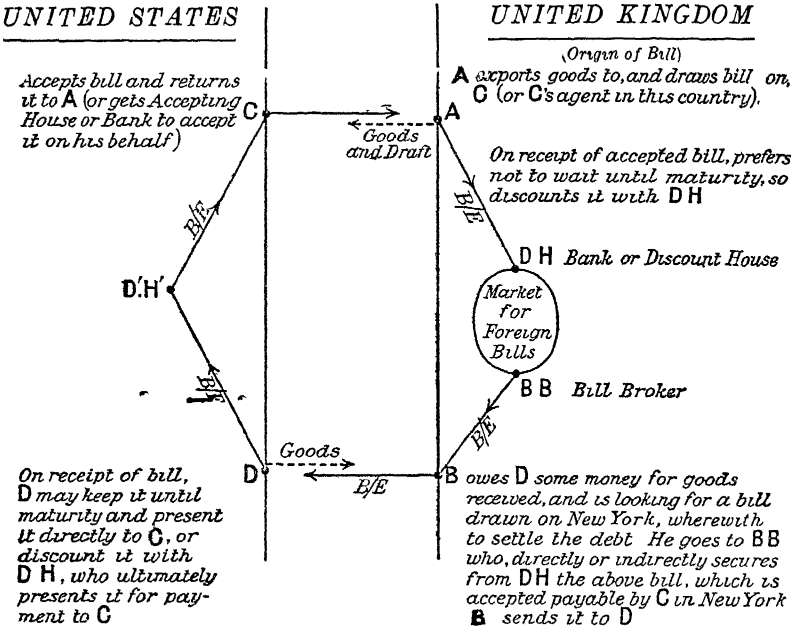
[1] See p. 224 note on the acceptance and discounting of bills.

Journey of a Bill of Exchange

The following diagram illustrates in simplified terms the general mechanism of international payments rather than an actual transaction The imaginary journey of a bill begins with *A* and, in this diagram, is in a clockwise direction In practice a bill rarely goes the whole round The banks on both sides act as clearing agents, and arrange remittances



(Origin of Bill)

A *exports goods to, and draws bill on,* **C** *(or* **C**'*s agent in this country).*

Accepts bill and returns it to **A** *(or gets Accepting House or Bank to accept it on his behalf)*

On receipt of accepted bill, prefers not to wait until maturity, so discounts it with **D H**

D H *Bank or Discount House*

B B *Bill Broker*

On receipt of bill, **D** *may keep it until maturity and present it directly to* **C**, *or discount it with* **D H**, *who ultimately presents it for payment to* **C**

B *owes* **D** *some money for goods received, and is looking for a bill drawn on New York, wherewith to settle the debt He goes to* **B B** *who, directly or indirectly secures from* **D H** *the above bill, which is accepted payable by* **C** *in New York* **B** *sends it to* **D**

Section 2. The Rate of Exchange

Exchange of Currencies

If British money were legal tender abroad or foreign money were freely accepted in this country, payments between this and other countries would be considerably simplified. It is because British debtors have to buy foreign money to meet their obligations abroad and foreigners have to buy British pounds to pay their debts here, that the complexities of the foreign exchanges arise.

Where the total demand for a country's currency, both on current and capital account, exceeds the demand by that country for foreign currency, there will usually be a premium on the home currency and the rate of exchange will move in its favour. Perhaps, too, there will be an inflow of gold to make up the balance The opposite applies where the demand on both accounts for a country's currency is less than the demand by that country for foreign currency.

In the absence of a universal standard currency some common measure of value has to be obtained. When the free market for gold existed this metal served the purpose. In recent years the restrictions on gold movements and the almost universal exchange controls have obscured and complicated the situation. For simplicity, however, the traditional system resting on a specie basis may first be described.

The Mint Par of Exchange indicates the equivalence between the standard coinages of different countries as determined by a comparison of their weights and fineness Where one of the countries has a paper currency and a nominal gold unit, the mint par of exchange of that unit is calculated, and then converted into terms of paper money according to the ratio-value of gold to paper.

The same procedure is adopted where one of the countries has a silver currency and a nominal gold unit.

Where a country has a silver currency only, the rate of exchange is chiefly determined by the market value of silver in terms of gold.

Variations in the Rate of Exchange

Debtors who have to meet claims in another country may require bills of exchange payable there, while creditors for amounts due to be paid in that country may offer their bills for sale Banks and brokers serve as the intermediaries The price of a bill, or, in effect, the rate of exchange, depends upon conditions of demand and supply, which in turn are largely governed by the relative amounts of imports and exports

A country whose imports have exceeded her exports will have accepted payment of a greater value of bills than will be payable to her. The supply of bills drawn on her will be relatively great, the demand for them relatively small. Hence, the price of the bill will tend to fall below par; i.e the exchange will be at a discount

On the other hand, a country whose exports have exceeded her imports will be a creditor for a greater value of bills than will be presented to her for payment. The supply of bills drawn on her will be relatively small, the demand for them relatively great Hence, the price of the bill will tend to rise above par; i.e the exchange will be at a premium.

Where the imports have been balancing exports, and the supply of, and demand for, bills are equal, the price of a bill and therefore the exchange will tend to be at par.

The monetary policy of a country has an important bearing on the value of its currency abroad If an inflationary policy is being pursued and home prices are tending to rise, the foreign demand for the depreciating currency naturally diminishes. Also the home demand for foreign currency increases. The rate of exchange, therefore, moves against the country with an inflated currency.

It was observed in Chapter XIII that debasement of the coinage, or over-issue of notes, causes a rise in the general level of prices. Higher prices tend to bring about a fall in exports and an increase in imports, which between them are liable to result in an adverse exchange.

Since a par of exchange between two countries implies equivalence between their standard currencies, over-issue of one of them must necessarily be followed by a fall in the rate of exchange, unless the other country's currency has suffered to the same extent.

Theoretically there is a tendency for the purchasing powers of different currencies to reach a parity. Suppose for example, that the rate of exchange between countries A and B is 1 : 20, and that the government of B inflate the currency until the price-level is twice as high as before, but that in A currency conditions remain unchanged. The rate of exchange, or purchasing power equivalence, tends under the new conditions to be 1 . 40 In practice, however, various exchange controls, which will be noted below, may check or conceal such a tendency.[1]

Limits to Fluctuations : Gold Points

A debtor buys a bill of exchange for the purpose of settling a debt only so long as it is cheaper than, or at least as cheap as, sending bullion A creditor accepts a bill of exchange in settlement of a debt only so long as it is not more advantageous to have bullion remitted instead

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[1] The following table gives the official rates of exchange for a number of leading currencies in relation to sterling

FOREIGN EXCHANGE RATES
Average of Daily Mean Rates

	New York	Montreal	Zurich	Paris	Brussels	Amsterdam	Frankfurt	Milan	Stockholm
	$	$	Francs	Francs	Francs	Florins	Deutschemarks	Lire	Kronor
1938	4 89	4 92	21 37	170 65	144 65	8 89		92 93	19 40
1951	2 80	2 95	12 24	979 74	139 97	10 64			14 48
1953	2 81	2 77	12 19	982 76	140 12	10 59	11 70		14 52
1955	2 79	2 75	12 23	978 10	139 56	10 62	11 74	1,751 16	14 48
1956	2 80	2 75	12 23	982 74	139 47	10 64	11 71	1,751 48	14 48
1957	2 79	2 68	12 24	984 88	140 27	10 64	11 73	1,752 13	14 47
1958	2 81	2 73	12 23	1,177 51	139 41	10 59	11 72	1,744 58	14 48
1959 (Aug)	2 81	2 68	12 12	13 78*	140 38	10 62	11 75	1,743 64	14 54

* Following revaluation in Dec , 1958

Specie or Gold Point is the term applied to that point above or below the par of exchange at which it is cheaper to export or import gold than acquire a bill of exchange.

When gold was freely available, at least for overseas payments, there were definite limits to the rise or fall of the exchange rates above or below par. If the price of a bill to a debtor rose so much that it was cheaper for him to send gold, the higher limit to the price of the bill was reached. This limit was termed the *export gold point*. Conversely, if the price of a bill fell sufficiently the *import gold point* was reached.

From the point of view of the foreigner, our export point was his import point, and our import point his export point.

Automatic Correction of an Adverse Exchange under a Free Gold Standard

In the long run, where the free gold standard was functioning, an adverse exchange rate tended automatically to correct itself. A country which had been importing in excess of her exports had the exchange turned against her. Owing to bullion payments in settlement of the balance the stock of gold, together with the credit based upon it, diminished in the debtor country and increased in the creditor country. Prices thus tended to fall in the first country and to rise in the other. Theoretically an adjustment of imports and exports would occur in the respective countries, until the exchange rate ultimately righted itself

A movement of the exchanges against sterling was usually a sign that the export gold point was being approached, if not yet passed. To prevent undue depletion of the gold reserve, the Bank Rate might be raised. For reasons previously explained, the outflow of gold would be checked and the inflow encouraged If the discount rate was higher in London than in New York, Americans would tend to transfer money to London, where it commanded a higher price. This was effected by purchasing British bills, which were equivalent to so much money in London. Also, the London branches or agents of American houses might draw bills on New York and sell them in London. The result of an increased demand for London bills and an increased supply of American bills would be a rise in the price of London bills and a fall in that of New York bills—i e. an improvement in the British exchange.

Regulation and Correction of Exchange Rates

In recent years the governments of the principal countries have found it necessary to impose some control over the foreign exchanges In 1932 the British Government, operating through the Bank of England, decided to establish an Exchange Equalization Fund for the purpose "of strengthening the currency and checking undue fluctuations in the exchange value of sterling " The very size of the operations was regarded as a powerful safeguard against private speculation, though it was not expected that, in the uncertain world conditions, absolute stability or freedom from loss could be guaranteed Exchange equalization funds were also established in the United States, France and elsewhere Such methods, however, proved insufficient to cope with the especial difficulties following the Second World War, and, as will be noted later, more radical measures had to be employed, entailing in 1949 a further devaluation of sterling.

It may be convenient to summarize the various devices adopted in different countries to correct exchanges and to prevent flights of capital and depletion of reserves.

(*a*) *Depreciation.* Some governments have taken the easiest course of allowing the exchange rate to depreciate until comparative stability is reached.

(*b*) *Deflation.* A government may prefer to pursue a policy of deflation, i e. curtailing the amount of money in circulation, thereby reducing home prices, stimulating exports, and discouraging imports.

(*c*) *Devaluation* Or it may decide to devalue its currency, i e. to reduce the gold parity of the standard money. By so doing (assuming that other countries do not follow suit) it lowers the exchange rate of its currency in terms of other countries' currencies. While imports are restricted, the export trade benefits, since payment for imports calls for a larger amount of the devalued currency, and exports are encouraged for the reason that a given amount of foreign currency is convertible into a larger value in home currency.

(*d*) *Import duties and quotas.* In order to reduce imports a government may impose new, or raise existing, tariffs. Or it may introduce a quota system, which lays down the maximum quantity of any commodity that may be imported within a certain period. Each supplying country is usually given its portion of the quota, determined by its share of the total in previous years.

Exchange Controls

Besides the above measures, special devices have been employed in some countries to effect a more direct and continuous control of the exchanges The following are the most common—

(*a*) *Centralization of transactions.* All foreign exchange dealings must be effected through a central office. Home currency may be obtained in any quantity at the official rate in exchange for foreign money, but no national may obtain foreign exchange unless it is considered to be in the country's interest—e.g. to pay for vitally necessary imports.

(*b*) *Blocked accounts.* This device was extensively employed by Germany in the years before the second world war. Imports were often paid for in "blocked" marks, which could not be drawn upon except for expenditure within Germany. In consequence most suppliers refused to offer goods unless they were guaranteed payment in their own currency and free from restrictions.

(*c*) *Clearing and payments agreements.* Among the arrangements devised for the benefit and protection of traders is the clearing agreement which, in its simplest form, requires that payment for goods from a country practising exchange control should be made in the currency of the importing country and that it should be retained in a special fund. Exporters from the latter to the former country receive payment from this fund. A drawback of this scheme is that creditors may have to wait a considerable time before being paid out of the fund; latterly an improved form of payments agreement has been employed whereby a certain ratio of exports and imports between the contracting countries is agreed upon and long delays before payment are largely obviated.

It is obvious that methods such as these are a source of considerable friction and delay, and that they have played no small part in hindering world trade.

The International Bank and Monetary Fund

The urgent need for some effective international banking organization has become widely recognized in recent times, and some progress in that direction has been achieved.

In 1930 the Bank for International Settlements was instituted, with headquarters at Basle, originally for the purpose of facilitating war reparation payments, but subsequently for promoting fuller co-operation between the central banks The B I.S could hold gold deposits for these banks and rediscount bills. In other ways too it was designed to improve and strengthen trading relationships.

The outbreak of the Second World War inevitably curtailed the scope and activities of the B I S

At the conference of the United Nations at Bretton Woods in 1945 it was decided to establish an International Monetary Fund and an International Bank for Reconstruction and Development

The object of the I M.F was to ensure that, where there was a basis for foreign trade, it should not be hampered through lack of means of exchange For this purpose a central fund was created to which each member nation contributed on an agreed quota basis Where accounts in terms of foreign exchange could not be settled between countries, arrangements were made for them to draw on their deposits with the fund

By these means it was hoped—

(i) to promote international monetary co-operation;

(ii) to facilitate the expansion and balanced growth of foreign trade;

(iii) to promote exchange stability and maintain orderly exchange arrangements between members; and

(iv) to assist in the establishment of a multilateral system of payments in respect of transactions between members.

The aims of the International Bank were—

(i) to help the member countries to re-establish their economies;

(ii) to assist in the utilization of resources, including those of less developed countries,

(iii) to promote foreign investment by guarantees and loans

Since 1947, when these institutions came into operation, a number of countries have been assisted and some notable projects have been promoted, despite the difficult international situation and the continuing restrictions on commerce

European Payments Union and Monetary Agreement

A limited scheme was established in 1950 under the Organization for European Economic Co-operation (O E E C). The European Payments Union (E P U.) provided for the clearing of debits and credits between Western European countries, using the Bank for International Settlements as its instrument By means of short term loans and other facilities it was intended to stabilize exchange rates and facilitate inter-European trade Under the scheme a member country which was in deficit on its current trade with the others was required to meet part of its deficit in gold or dollars, leaving the balance to be paid in its own currency at a later date.

The E P.U , by automatically extending credit in the currencies of the member countries, helped greatly to stimulate trade Gradually, with an improvement in conditions, a further measure of liberalization became possible In 1955 the European Monetary Agreement was drawn up, and provision was made for it to become effective when members of the E P U responsible together for at least half the total E P U quotas decided to make their currencies convertible The agreement had two parts · a Multilateral System of Settlements and a European Monetary Fund, both to be supervised by the O E E C. Unlike the E P U arrangement, credit would not be granted automatically, but only at the discretion of the O E E C

With the extension of convertibility at the beginning of 1959 among the leading West European nations[1] (including the convertibility of sterling belonging to those outside the sterling area), the E.P U. was wound up and the E M.A. came into force

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[1] See p 329

CHAPTER XVII

INDUSTRIAL FLUCTUATION AND EMPLOYMENT

Characteristics of the Trade Cycle

PERIODS of good and bad trade appear from the published records to have taken place with a certain regularity during the past hundred years. An examination of the figures of unemployment or of trade returns, so far as they are available, reveals a periodicity in trade movements that suggests a cyclical trend. Thus, for example, the unemployment percentage, based on trade union returns, moved up and down during the second half of the nineteenth century, the normal maximum being in the neighbourhood of 7 per cent (in abnormal years, such as 1879, it rose to over 11 per cent), declining in the good years to less than 1 per cent.[1] Though there was no uniformity in the actual rates of increase or decrease, nor an exact parallel in economic conditions during the periods, there was a sufficient similarity between the general movements to warrant the belief in a certain rhythm in the ebb and flow of trade. The statistics indicated a period of seven or eight years for the cycle to complete itself, though here again there was no uniformity.

The trade cycle manifests itself not only in the level of employment, but more fundamentally, as will be shown later, in the volume of income and expenditure and in the rate of investment. The degree of fluctuation varies from one type of industry to another. An industry making capital goods is liable to be more vulnerable in that existing supplies of its products are in general more durable than consumer goods, and the demand is apt to be more uneven.

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[1] Unemployment among non-unionists was not recorded, and would have greatly increased the above percentages

Theories of the Trade Cycle

Much thought has been given in recent years to the conditions responsible for trade fluctuations. Opinion still differs, however, on the relative importance of the underlying factors, and on the effectiveness of preventive, as distinct from ameliorative, measures

(1) **Unbalanced Production.** In the account of labour conditions reference was made to the imperfect co-operation of producers as a factor in unemployment. The lack of co-ordination holds a central position in the over-production theory of the trade cycle The sequence of events in this cycle, in which it is claimed there is a chronic propensity at certain stages to overproduce, may be briefly described. To begin with, suppose trade to be improving. Under such conditions there is a keen demand for money to assist in further production, and credit facilities are extended. Prices rise because of the greater amount of effective money in circulation, and thus may encourage even greater activity. New firms, attracted by the profits, enter the field, and for a time there is general prosperity. Speculation may go beyond legitimate bounds. In the absence of any co-ordination, or a satisfactory index of the exact amount of goods that can be economically produced, there is a distinct risk that total output will be in excess of the existing demand. The result is a fall in prices and a certain curtailment of production. Firms near the margin disappear, banks raise their interest and call in their credits, prices fall further, and for a time there is a general depression. After a while it is found that too little is being produced to meet the demand. The shortage of goods sends prices up again,

production revives, and so, with the improvement in trade, a new cycle begins again.

(ii) **Unbalanced Consumption.** In other quarters emphasis is placed on the disproportionate expenditure by the community on production (capital) and consumption (final) goods. In a simple form the theory maintains that there are periodical bursts of activity due to the discovery of new resources, accompanied by heavy investment in production goods As the demand for these is not continuous a slump occurs in the capital industries and indirectly in the dependent industries

Another form of the over-investment theory, associated with J. A Hobson, draws attention to the effects of the unequal distribution of income, and consequently of saving and spending. It is held that the wealthy sections of the community normally save such a large amount of their income that the total capital investment is greater than it would be if the total income were more equally apportioned. The quantity of production goods is increased as a result of this investment, and so also is the output of consumption goods. The demand for the latter, however, cannot keep pace because of the insufficient volume of income going into the pockets of the masses of consumers. Thus the industrial system tends to become congested with unsold products. This brings about a reduced demand for labour and capital, a period of low production, and a fall in the social income. The amount of the "surplus" income falls, too, and for a time there is a more balanced ratio of saving to spending. But, as the aggregate income rises again, the proportion of savings increases at a greater rate, and eventually, in Hobson's words, the "chronic impulse due to surplus income again becomes fully operative, preparing a new period of depression."

Critics of the under-consumption theory are not satisfied that the cyclical fluctuations would not still occur if the social product were more equitably distributed. Though heavy taxation, accompanied by extensive transfer expenditure in the form of the social services, has caused private savings to decline, it would be premature to claim that the liability for depression to recur has thereby been greatly offset The notion, however, is not without significance. Though it may not offer a complete explanation of the causes of the trade cycle, it brings out the close and physical relationship between distribution and production, and focuses attention on the frequent lack of adjustment between expenditures on capital goods and consumption goods and on the consequent dislocation pending the restoration of the balance.

(iii) **Psychological Factors.** When trade is good, people are optimistic; they buy more and prices rise; production is stimulated. Conversely, when trade is bad, people are pessimistic, they stop buying, prices fall, and production is checked Professor Pigou, who attaches great importance to the psychological factor, states that it would be a "fallacy to infer . . . that, because the trade cycle always presents itself in a money garment, therefore the forces that underlie its movement necessarily reside in the money system." He admits that "the monetary and banking arrangements . . . cause errors of optimism and errors of pessimism to be larger than they would be in a regime of stabilized general prices . . . But to grant this is not to grant errors of optimism and of pessimism are merely monetary phenomena."

(iv) **Monetary Factors.** Some economists see in the ill-balanced working of the monetary and financial machine a primary cause of cyclical fluctuations. They point to the liability of bankers to issue credit facilities in excess of the amount justified, to the encouragement of speculative undertakings, and to the rise in prices that calls for further money supplies and induces further production. Eventually there arises a state of over-production which is due not only to the lack of co-ordination in the prevailing system but also to the unnatural stimulus of the monetary machine.

The monetary theories vary considerably in the emphasis they respectively place on the various factors. Dr. Hayek,[6] for instance, attributes trade fluctuations to discrepancies between the low rates of interest that the bankers are apt to charge and the true economic rates that current conditions would properly justify. He maintains that bankers have such latitude and powers, and are ordinarily so keen to get business, that they are apt often to issue credit at too low rates, having regard to the supply of savings and the prevailing demand. In consequence there may be an expansion in production that is not genuinely warranted. This expansion must be checked sooner or later by the inadequacy of new savings relative to the demand, and a crisis is precipitated

On the other hand are those who take the view that a controlled low rate of interest can bring about an expansion of business and, what is more important, help to maintain it at a satisfactory level. They disapprove of the erstwhile, almost traditional, practice of raising the interest rate as a means of staving off a crisis Instead they favour a retention, and even a lowering, of the rate in order that the flow of production and income may be maintained [1]

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[1] Certain economists in the nineteenth century were inclined to attribute industrial fluctuations to climatic changes The state of manufacture and commerce was stated to be dependent on conditions in agriculture, the basic industry, which in turn was particularly susceptible to climatic forces. Drought or famine, for instance, was apt to have serious repercussions throughout the entire economic system Notable among the early attempts at explanation was Jevons's "sunspot" theory, according to which there was alleged to be a causal relationship between spots on the surface of the sun, variability in the

Savings, Investment and Employment

New light was thrown on the subject of industrial fluctuations by the writing of Lord Keynes, notably *The General Theory of Employment, Interest and Money,* published in 1936. The attitude to unemployment underwent a marked change, so much indeed that full employment came to be regarded as a feasible objective of Government policy, quite apart from the special circumstances of labour shortage that developed during and following the Second World War.

The Keynsian approach may be briefly described In order that full employment may be maintained it is necessary that the effective demand for goods and services should be sufficient to absorb all the output of the economic system. In other words, the total costs of industry and commerce must be covered by the income of industry and commerce. As all costs consist in the final analysis of payments to individuals, this means that all the income received by individuals must be returned into the system.

The individual can use income for two purposes. spending and saving The money he spends goes back into the system directly in the form of demand for goods and services, and so no longer concerns this argument. The income which he saves is, in effect, held back from immediate circulation and is either hoarded, thus being withdrawn for a time from useful employment, or is put into the hands of some agency such as a bank or an insurance company to keep for him In the latter case the money is available for loan to firms or individuals, and much of it goes to the purchase of capital goods, such as machinery and factory buildings.

When individual incomes are saved and investment follows there is no problem, but when saving is not

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amount of heat emitted, and the conditions of rainfall and agriculture throughout this planet This and other climatic theories are no longer accepted as primary explanations of trade movements translated into investment the demand for goods is insufficient to cover all that is being produced. Output must therefore be reduced, and unemployment results

The importance of this approach to the problem lies in the fact that it emphasizes the necessity for equality between saving and investment In practice these functions are, to a large extent, performed by different groups of persons, and it can only be accidental if the results of their respective decisions to save and to invest should involve equal amounts of money. In fact, it has been the general experience that the amount of money which people decide to save tends to be in excess of the volume required for the maintenance of plant and the provision for normal development and expansion. It is only in times of very rapid technical change and innovation that investment must necessarily equal savings. This was the position during the greater part of the nineteenth century, when technical advances were taking place at a rapid rate at home and abroad. In recent years, more particularly in the period between the wars, savings have tended to exceed investment, with adverse effects on employment.

The question arises, what happens when, under conditions of unemployment resulting from this deficiency of investment, an increase of investment takes place?

The increased demand for capital goods is followed by greater employment in the capital goods industries. This is followed by a larger demand for consumer goods by the re-employed workers This, in turn, is followed by further employment in the consumer goods industries. The operation of the "multiplier" thus tends to spread throughout the economy

Public Policy and Employment

In 1938, as is shown in the following table, unemployment in Britain exceeded 1¾ million, or about 13 per cent of the working population In 1944 the Government, in announcing its aims for the post-war years, declared that a primary objective would be "the maintenance of a high and stable level of employment" Since the chief cause of unemployment was held to lie in the failure to maintain internal expenditure on an adequate scale, broad lines of policy for sustaining demand, and for stimulating it in times of difficulty, were laid down

REGISTERED UNEMPLOYED IN GREAT BRITAIN[1]

	1938	1947	1948	1949	1950	1051	1952	1953	1954	1955	1956	1957	1958	1959 (Dec.)
Total (000)	1,791	480	310	308	314	253	414	342	285	232	257	312	457	421
Per cent	13 9	3 1	1 8	1 6	1 5	1 2	2 0	1 6	1 3	1 1	1 2	1 4	2 1	1 9

[1] Ministry of Labour (The figures were higher in N Ireland)

In the period immediately following the war some transitional unemployment was unavoidable, but even so it did not reach the pre-war figure In 1947 the number out of work was about 500,000 More as a result of reconstruction and re-stocking needs than of specific government measures and the number of unemployed fell by 1955 to under 250,000 The figure rose to over 600,000 by the beginning of 1959, but, with the improvement in trade conditions, fell to about 400,000 by the end of that year The ratio then of 2 per cent compared favourably with that in the U.S A, and some leading European countries The more generous scales of unemployment benefit and assistance caused individual hardship to be less severe than in former times and helped to maintain the general level of demand

The underlying changes in these years and the modifications in policy are considered in Part VI

PART V

PUBLIC POLICY AND FINANCE

CHAPTER XVIII

PUBLIC UNDERTAKINGS AND SOCIAL SERVICES

THERE are certain functions which are universally recognized as being proper and necessary for the State to perform

(*a*) The maintenance of law and order. While this function extends beyond the economic field, it is of especial importance in ensuring the smooth running of industry, the observance of contracts, etc.

(*b*) The undertaking of certain services which, especially in modern communities, cannot be provided effectively or economically by private enterprise.

(*c*) The furtherance and protection of national interests in world trade and affairs.

Apart from performing these general functions, the State participates in varying degrees in the economic activities of the nation. These may for convenience be considered under the heads of (i) industrial, and (ii) social, intervention, though the dividing line is not always clear, especially in the modern Welfare State.

Public Intervention in Industry

The State has come to intervene in particular branches of industry in a number of ways, viz.—

(*a*) Where private enterprise fails to supply an essential service or commodity in adequate quantity, either because of an insufficient profit, or because the undertaking is such that a very long period must elapse before a return is possible (e g. afforestation);

(*b*) Where private enterprise supplies a service or commodity of poor quality (e.g. inferior foods);

(*c*) Where, to avoid physical overlapping and to secure economies on a national scale, a public monopoly is desirable (e g. electricity, gas and water supplies, postal service, etc.);

(*d*) Where the supply is in the hands of a monopolist concern which is taking unfair advantage of its position.

(*e*) Where it is necessary for political or other reasons that the State should directly provide for its own requirements (e g atomic energy development).

Stages of Intervention

The main stages in the order of government participation in industry may be roughly classified. The divisions are by no means rigid or exclusive.

(*a*) *Public Facilities.* These include such central and municipal functions as the provision of currency, standard weights and measures, fairs, markets and exhibitions, etc.

(*b*) *Public Encouragement.* In some ways similar to (*a*), this goes further and provides a stimulus to economic activity by means of research and technical institutions, information bureaux, protective duties, subsidies, etc.

(*c*) *Public Regulation and Control.* A more advanced stage is reached when the public authority decides to regulate and control an industrial or commercial concern. Such intervention may range from a simple regulatory action, without any actual participation, to a full control of the undertaking. Though the ownership of the business may still be in private hands, the direction may rest more or less with the public body. Thus a public utility undertaking which may be partly or wholly financed by private capital, is given certain monopoly rights, provided that the price and quality of the product or service are in accordance with specified conditions. Governments of late have greatly extended their activities in the direction of price and quality control.

(*d*) *Public Ownership.* The final stage is reached when the public authority, not content with powers of regulation and control, acquires the ownership of the undertaking.

The policy may now take either of two forms—

(i) To continue the service on a more or less commercial basis—e g. the Post Office, the railways, the coal mines, etc

(ii) To provide the service without specific charge, and meeting the cost out of general revenue—e g. the freeing of bridges and roads for which tolls to private owners had formerly to be paid.

Public Intervention in the Social Field

Public intervention in the social field is largely concerned with safeguarding the individual against certain hazards to which he is liable under present-day conditions, and with providing him with those amenities which modern society requires. Government action takes a number of forms—

(*a*) General legislation benefiting the community as a whole, e g smoke nuisance abatement schemes.

(*b*) Legislation benefiting the consumer, e g Food and Drugs Acts The regulations which governed the qualities and prices of "utility" clothing might also be placed in this category.

(*c*) Legislation guarding against unsatisfactory working conditions, e g. Factory and Shop Acts.

(*d*) Legislation protecting workers in certain industries against under-payment, e g the Wages Councils Act and the Agricultural Wages Act.

(*e*) Provision of social services, paid for to a large extent out of taxation.

The Welfare State

In the modern Welfare State the range of these social services has been greatly increased It is now an accepted object of public policy to ensure that all those in want should be provided with a minimum living standard To this end comprehensive schemes have been instituted, partly on a contributory insurance basis, partly non-contributory and available to all who are in need

National insurance provides for money payments in the event of unemployment, sickness, industrial injuries and diseases, maternity, widowhood, retirement and death. Contributions are payable by employers, employed, self-employed and non-employed, on a graduated scale, and out of funds from the Exchequer.

National assistance, the cost of which falls entirely on the taxpayer, is available, under certain conditions, to all who prove need, including those requiring help in supplementation of an insurance benefit or contributory pension

Non-contributory old-age pensions are payable ordinarily to persons aged 70 and over Family allowances are paid from exchequer funds for each child after the first

The National Health Service, inaugurated in 1948, is non-contributory, and everyone is entitled to make use of it. The scheme includes medical, dental, ophthalmic, hospital and specialist services, and, subject to certain charges, the provision of drugs and appliances [1]

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[1] The extension in recent years of public ownership and of social services is dealt with in Chapter XXII.

CHAPTER XIX

PUBLIC REVENUE AND EXPENDITURE

Section 1. *The Rules of Taxation*

The Budget and the National Income

GOVERNMENT budgets have increased in recent years not only in amount but in proportion to the national income. In this country tax revenue accounted for only 10 per cent of the total income in the years before the First World War, rising to nearly 20 per cent on the eve of the Second World War By 1958, as is shown in the table opposite, taxation had increased to £6,500 million out of a national income of £20,000 million, representing almost 33 per cent In addition, the local authorities raised in that year about £650 million in rates (p 297), bringing the proportion to over 35 per cent If government borrowings and other receipts were taken into account, the proportion of the national income appropriated for public purposes would be in the region of 40 per cent [1]

While the increase in this proportion has largely been compelled by circumstances, it has partly come about as the result of deliberate change in public policy From being primarily a purely financial instrument for providing the Government with necessary funds, the Budget has evolved into an instrument of policy. Because of its character as well as its scale it has become the most influential single factor in the national economy. The Chancellor is empowered thereby to mould the pattern and direction

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[1] In the United Kingdom the income from publicly-owned property and undertakings accounts for only a modest proportion of the total revenue In some Socialist countries, as well as in those where valuable natural resources (such as Middle East oil) are owned by the rulers, the ratio is much higher.

CENTRAL GOVERNMENT REVENUE AND EXPENDITURE[1]

Main Items

£ million

	1946	1949	1952	1955	1958
TOTAL REVENUE	3,357	4,320	4,999	5,592	6,584
Taxes on Income					
Income tax	1,250	1,370	1,651	1,941	2,278
Surtax	75	110	128	132	161
Profits tax	35	257	378	197	276
Taxes on Capital					
Death duties	143	190	157	184	182
Taxes on Expenditure					
Customs and excise duties	1,165	1,518	1,754	1,960	2,188
Motor vehicle licence duties	46	54	67	85	105
Stamp duties	36	53	53	75	61
National Insurance Contributions	170	436	476	594	859
TOTAL EXPENDITURE	3,357	4,320	4,999	5,592	6,584
Defence	1,560	770	1,445	1,505	1,551
Health services	—	369	436	500	624
Housing subsidies	36	59	69	79	89
Agriculture and food subsidies	286	424	315	238	272
National insurance	133	379	473	614	912
Assistance grants	54	51	95	103	122
Family allowances	20	63	80	111	130
War pensions and service grants	76	76	76	86	95
Grants to local authorities[2]	243	286	369	469	635
Debt interest	486	507	609	707	783
Surplus[3]	— 856	598	386	513	645

[1] *National Income and Expenditure* (Central Statistical Office), 1956/9

[2] See p 297

[3] Before providing for depreciation and stock appreciation

of production and consumption, to determine the apportionment of income, to regulate the purchasing power of the community, to foster or restrain particular forms of activity, and in other ways to regulate the economy of the nation.

The Nature of Taxation

A tax may be defined as *a compulsory contribution to the public authority to meet the expenses of government and the* *provision of general benefits.* It must be distinguished from a fee, which is a payment for a specific service.

Several theories purporting to explain the nature of taxation have been put forward at different times.

(i) **The "Benefit" Theory.** In the earliest days of taxation there was a certain connection between the contribution made and the benefit derived A feudal tenant might commute his manorial dues to his overlord by a money payment, while a lord might meet his obligations to supply military aid to the king by paying an equivalent annual sum. But these were not taxes in the modern sense If the benefit principle were applied to present conditions, it would imply that those who benefited most from the services of the State would have to pay the heaviest taxes—a situation which clearly would be impossible as well as unjust This theory is no longer maintained as applying to national finance, but a trace of it still lingers in local taxation, where, on account of the smaller area and population, it is more practicable, within narrow limits, to connect payment made and value received.[1]

(ii) **The "Financial" Theory.** A tax is sometimes regarded simply as a means of enabling the State to carry on. The exponents of this view are concerned not so much with the equity of the method of collection as with obtaining the necessary revenue as expediently and cheaply as possible. They maintain that any tax is good which yields a large income with comparatively little protest. The policy of "plucking the goose with as little squawking as possible" may not be advocated in such crude terms, but it commends itself nevertheless to finance ministers who prefer to follow the line of least resistance.

(iii) **The Socio-political Theory.** Latterly a tax has come to be regarded as an instrument of policy. It is in accordance with the socio-political view that differential taxation should be employed so as to reduce inequalities in incomes, or that fiscal devices should be used as a means of stimulating production.

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[1] See p. 296

(iv) **The Sumptuary Theory.** Certain commodity taxes serve to restrict the consumption of luxuries or of noxious articles. But, while this may be the ostensible purpose, the finance minister does not despise the revenue derived, which is frequently of such dimensions as to throw doubt on the sumptuary effect actually achieved. The purchase tax illustrates this dual purpose Varying in percentage according to the degree of necessity or luxury attributed to the article, it was intended to act as a curb on private expenditure as well as a source of revenue. The second objective has in fact become the more important.

Taxable Capacity

The extent to which a nation or an individual can be taxed without inflicting damage on the power and will to produce denotes the limit of taxable capacity. This limit, however, is a relative, not an absolute quantity. In times of emergency, such as war, the citizens are willing to make greater sacrifices than in ordinary times, and the capacity to pay is accordingly greater. In emergency, too, it may be necessary to use up capital resources, though ordinarily a system of taxation that encroaches on capital is open to severe criticism

The chief factors determining taxable capacity are—

(i) *The character of the taxation* Certain taxes are more scientifically devised than others, arouse less resentment, and are thus more likely to bring forth a satisfactory yield.

(ii) *The distribution of the national income.* As one's income increases, the proportion devoted to necessary consumption diminishes and the "surplus" available for taxation increases. The more equal the distribution of the social income, the smaller the aggregate surplus, and the less therefore the taxable capacity The more unequal the distribution the greater, up to a point, is the taxable capacity. (If, however, distribution were so unequal that production suffered, total income and taxable capacity might greatly decline.) A reduction in taxable capacity, that resulted directly from a more equal division of income, would not necessarily be a cause for apprehension, in so far as the need for public expenditure on the relief of poverty was correspondingly curtailed.

(iii) *The size of the population.* Where the national income is increasing faster than the population, the taxable capacity tends to increase, and *vice versa.*

(iv) *The nature of the public expenditure.* Where expenditure takes the form of an internal transference (such as interest on the National Debt), the limits of taxation are wider than where the expenditure involves a physical consumption of resources. Also, the taxable capacity is likely to be greater where the revenue is applied to productive as opposed to unproductive purposes.

(v) *Political and psychological factors* Circumstances of the time may affect the attitude and resistance of the taxpayer, and may influence accordingly the capacity as well as the will to pay.

Equity in Taxation

Some broad principles laid down by Adam Smith are still applicable to any sound system of public finance—

(i) "The subjects of every State ought to contribute towards the support of the Government, as nearly as possible in proportion to their respective abilities; that is in proportion to the revenue which they respectively enjoy under the protection of the State. . . .

(ii) "The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain. . . .

(iii) "Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it. . . .

(iv) "Every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible over and above what it brings into the public treasury of the State."[1]

The first of these maxims is usually known as the canon of equity If taxation is to be paid according to one's ability, it should be on a *progressive* scale, i.e it should rise more than proportionately to one's income.

As was noted in Chapter VI, a *proportionate* tax causes more sacrifice to a poor than to a rich man, and therefore fails to satisfy the rule of equity Progressive scales lend themselves more to direct than to indirect taxation. The proportionate burden imposed by commodity taxes is usually more than offset by the progressive nature of the scheme of taxation as a whole

Taxation is said to be *regressive* when the proportion of income taken in taxation diminishes as the income increases. While regression is, as a general rule, to be deprecated, it is sometimes unavoidable if the maximum revenue has to be obtained.

Economy in Taxation

While the first canon laid down by Adam Smith is essentially an ethical precept, those of certainty, convenience and economy are mainly administrative in character The rule of economy, the most comprehensive, could in fact be regarded as embracing the other two.

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[1] *Wealth of Nations*, Book V, Chapter II, Part II

The canon of *certainty* may be extended so as to require, on the one hand, that the taxpayer should know exactly what he has to pay, enabling him to make the necessary adjustments in his finances; and on the other hand, that the State should know as far as possible the amount of revenue likely to be derived.

Though the rule of *convenience* in taxation has special reference to the taxpayer, it may also be taken as applying to the Exchequer, which, in order to provide for large disbursements at particular periods, finds it an advantage if sufficient amounts of revenue are available when required.

The canon of *economy* requires that as little as possible consistent with efficiency should be spent on administration and collection. Some taxes entail less expense than others. Income tax, for instance, in relation to the total revenue raised, is comparatively cheap to administer The principle, in its broader sense, requires that a tax should be so devised that it does not discourage effort or impair production.

The principle of *economy* may be extended so as to include some additional rules of taxation not so far specified—

(i) A tax should have a high net *yield*, but not so high as materially to damage the wealth-yielding sources whence it is derived. A tax may be immediately productive of a large revenue, yet under certain conditions may ultimately result in a reduction in the nation's income, i.e. it may be the reverse of productive in the wider sense of the term.

(ii) It is preferable to have a *limited number of high-yielding taxes* rather than many with a low yield. This permits of a more effective administration and a lower cost of collection.

(iii) The yield from a tax should *grow automatically* as the income and population increase. Taxes on land (as distinct from land values), for instance, are not so satisfactory in this respect as those on incomes, or on commodities in wide and growing demand

(iv) A tax should be *elastic*, i e. it should allow, if necessary, of an increase in the rate and the yield without a corresponding increase in the cost of administration. Factors to be borne in mind are the nature of the commodity and the demand If the latter is very sensitive, an increase in the tax may lead to a fall in the yield.

(v) A system of taxation should be as *simple* and *intelligible* as possible, so as to reduce doubt and friction.

Summary of the Canons of Taxation

The canons of taxation may be re-stated in summary form—

(i) **Administrative.**

(*a*) *Yield* The revenue from a tax should be of adequate amount.

(*b*) *Elasticity*. In case of need the Exchequer should be able to increase the revenue without necessarily devising new taxes.

(*c*) *Certainty*. The amount and the time of payment should be known as far as possible.

(*d*) *Convenience*. The convenience not only of the taxpayer but also of the Exchequer should be considered.

(*e*) *Cost of administration*. A low cost of administration and collection is essential. A tax may seem desirable on grounds of equity, but the expenses may be so high as to swallow up an undue proportion of the revenue.

(ii) **Economic.** A tax should interfere as little as possible with a nation's wealth-producing capacities

It is short-sighted policy to aim at the maximum revenue without regard to the effects on future output.

(iii) **Ethical.** A tax should be adjusted as far as possible to *ability to pay*. Individual taxes may be proportionate or even regressive, but a scheme of taxation *as a whole* should be progressively conceived.

Section 2. The Incidence and Effects of Taxation

Factors Governing Incidence

The *impact* of a tax is said to be on the person from whom the tax is first collected. The *incidence* is said to be on the person who finally pays it If the two persons are the same, the tax is said to be direct; if they are different, i.e if the tax has been shifted, the tax is said to be indirect.

Incidence should be distinguished from *effects*, i.e. from the repercussions on economic activity, both of the individual taxpayer and of the community in general. As will be noted below, incidence and effects are to some extent interdependent.

Income tax and death duties present a comparatively straightforward problem of incidence; in general they are not shifted but remain at the point of impact.[1]

Incidence of Commodity Duties.

Commodity duties present a more complex problem. The main factors in incidence are—

(i) *Nature of the Tax.* Much depends on whether the tax is exclusive to a particular article or whether it applies to a whole class of commodities. If two articles are in alternate demand (say tea and coffee), and only one of them is taxed, it may not be practicable to raise the price by the full amount lest part of the demand be diverted to the other article Thus it is more difficult to shift a tax which is exclusive than one which is common to a group. Also, the amount of tax is of importance. If the tax is very small, the producer may bear it himself rather than go to the trouble of altering his prices, and thus possibly incur friction with his customers. This has happened on rare occasions when, for example, a small addition has been made to the tax on matches or tobacco

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[1] For a more detailed analysis see the author's *Taxation Its Incidence and Effects* (Macmillan)

(ii) *Conditions Inherent in the Object Taxed* Taxes on commodities are usually intended to be passed on.[1] The actual extent to which shifting occurs depends upon the nature of the demand (subject also to the possibility of substitutes) and also upon the conditions governing production

If the demand is relatively inelastic the consumer normally bears the whole of the tax. If the demand is highly elastic the tax may be borne partly by the producer.

If the article is produced under increasing returns (i e diminishing costs), and the addition of the tax to the price results in a smaller demand, a smaller output will tend to bring about a higher cost of production per unit. This may lead to a still further rise in the price, which may now include not only the amount of the tax, but also the extra costs. Thus the extra burden on the consumer may turn out to be greater than the amount of the tax.

If the article is produced under diminishing returns, and an addition to the price reduces the demand, a smaller output will tend to reduce the cost of production per unit. This will tend to prevent the price from rising by, and therefore the consumer from paying, the full amount of the tax. In practice, however, other cost considerations are likely to outweigh these tendencies.

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[1] This does not imply, however, that all commodity duties are indirect For instance, taxes on goods brought into a country by a person for his own consumption fall directly on that person

(iii) *Degree of Competition or Monopoly.* The force of competition sometimes prevents a tax from being passed on, particularly if it is very small. If the duty is charged on the commodity, its transmission may ordinarily be assumed. If it is laid on profits, however, competition may prevent it from being passed on. The presence of the marginal producer who makes no profit, or at any rate too little to become liable to income tax, may be sufficient to prevent his rivals from seeking compensation in higher prices.

Incidence under monopoly is readily understood from the general reasoning in previous chapters. If the tax is on the commodity, and if it is of small amount, it may be less disadvantageous for the monopolist to bear it himself than to raise the price (which he has the power to do if he wishes), provided he is already charging the highest price consistent with the maximum net revenue, which is his object. If the tax is very heavy, however, the monopolist may have no option but to increase the price, even though this may result in a reduction in sales.

Conversely, where the tax is imposed, not on the products, but on monopoly profits, it is unlikely to be shifted, provided, of course, that the tax is not so heavy as to cause a radical change in the entire production and price relationship.

Incidence of Customs Duties

Though the incidence of Customs duties is subject to the same general principles, some particular aspects, depending on the degree of seller's or buyer's monopoly, may be noted.

If, for instance, country *A* is the *only* market for *B's* *only* product, and exports in return commodities for which *B* has a very inelastic demand, it may be possible for *A* to impose a tax on *B's* goods which the merchants in *B* have to bear. Or if country *A* has a monopoly of something urgently required by *C*, but has a demand for *C's* product that is very elastic, an *export* duty on the goods so urgently required by *C* might be passed on to that country.

Such circumstances, however, are of hypothetical rather than practical interest. The British import duty on Greek currants comes partly within the first-mentioned category; the export duty on nitrates and coffee from South American countries is a rough example of the second. A "snap" duty suddenly imposed may catch the foreign producers unprepared, rather than suffer complete loss, they may for the time being bear part of the tax themselves. But to obtain from them a permanent contribution to home revenue is another matter. In the long run the tendency remains for the burden to be transmitted to the consumer in the importing country; otherwise the foreigner will seek an alternative market.

Conditions Affecting or Concealing Incidence

In studying the relationship between taxation and prices, the following cautions should be borne in mind—

(*a*) Though the price remains nominally unaltered, the consumer pays the tax if the quality or the size of the article is reduced to compensate for the duty; e g. the production of weaker beer or smaller cigarettes.

(*b*) External factors may conceal the incidence of a duty. The price of a newly taxed article may be tending to drop (e g on account of an increasing scale of production) and in such circumstances the retention of the old price is tantamount to an increase. Similarly, changes in monetary conditions may cause general prices to fall or rise, thus rendering the true incidence more difficult to trace, and concealing perhaps the true situation

(*c*) Prices may be altered following the imposition of taxation, but not necessarily as a result of straightforward shifting A tax may cause such changes in supply and demand as to bring about a new price structure. In such circumstances the change in price becomes a problem not of incidence but of effects.

Effects of Taxation

It is not always possible to discern where the problem of incidence passes over into that of effects, and some of the reactions of particular taxes have, in fact, already been indicated or implied. The chief economic effects of taxation may be classified as follows—

(i) **Effects on the Standard of Living and Efficiency.** Where taxes are levied on necessaries of life there is a danger lest they should depress the real income of those workers who are already at the minimum standard required for full efficiency, and thus cause a shrinkage in the volume of production.

(ii) **Effects on the Scale of Production.** On the assumption that the demand for a taxed article is elastic, an increase in the price entails a contraction in the scale of production. If the article is being produced under conditions of diminishing returns (i.e. increasing costs), the price, as already shown, may not rise by the full amount of the tax. But if, as is more likely, it is being produced under conditions of increasing returns (i e. diminishing costs), the duty is liable to result in some economic loss.

(iii) **Effects on Savings.** High taxation may restrict savings, and thus affect the supplies of capital for production—

(*a*) Directly, by reducing the taxpayer's surplus of income over necessary expenditure. The effect here is a physical one.

(*b*) Indirectly, by discouraging the taxpayer from investing such surplus as he may have available, especially in so far as "unearned" incomes are taxed at a higher rate. The effect here is partly psychological.

(iv) **Effects on Enterprise.** Under this head, too, both physical and psychological effects may be observed.

(*a*) The smaller savings noted in (iii) may prevent a business from expanding, even though the will and the ability are present.

(*b*) The liability to heavy taxation may exert a generally depressing influence, and serve to discourage business men from embarking upon new ventures.

Government Revenue and Expenditure

The main forms of taxation, falling respectively on income, capital and expenditure, will be considered in the next chapter. For a broad idea of their relative importance as revenue producers, reference may be made to the table on p 275

Taxes on income are shown to account for more than a third of total revenue Income tax and surtax amounted to nearly £2,500 million in 1958 The marked increase in the figure over the pre-war level (the yield was less than £350 million in 1938) was due largely, apart from the general rise in money incomes, to the higher rates of tax and to the greater number of people who became liable Taxes on company profits have become an important means of revenue.

The yield from taxes on capital, i e death duties, is shown to have increased at a smaller rate, notwithstanding the very heavy impost on large estates

While the yield from income tax roughly equalled that from customs and excise duties, the revenue from all taxes on income and capital slightly exceeded that from taxes on expenditure.

National insurance contributions are included in the revenue table since they are for practical purposes a form of tax, and have their counterpart, in the expenditure table, in the national insurance payments which expanded over the period at a greater rate More details of this form of expenditure are given in the table on p. 331.

Among the expenditure items defence is easily the largest Even after a number of economies it still represented in 1958 almost 25 per cent of the total Another heavy item is interest on the National Debt, which largely reflects defence expenditure in the past.

The increase in the cost of the social services—health, insurance, assistance, family allowances, etc —is clearly brought out So is that of the related subsidies on housing and food

Hitherto in the presentation of the financial statements the items "above the line" comprised expenditure and revenue on current account, while those "below the line" covered long-period capital expenditure and corresponding repayments It was considered sufficient to balance the items "above the line," leaving the remainder to be adjusted by borrowing With the decline in public savings on the one hand, and the heavy war and post-war commitments on the other, it was found desirable to rearrange the financial statement so as to balance the items as a whole Accordingly, it became the practice to budget for a so-called surplus "above the line" in order to cover the outgoings "below."

CHAPTER XX

NATIONAL AND LOCAL TAXATION

Section I *Direct and Indirect Taxes*

Income Tax

THE income tax in its modern form was imposed as a war measure during the Napoleonic Wars, and was repealed after Waterloo. It was re-introduced in 1842, for a period of three years only, but it proved so remunerative that, after a series of renewals, it became permanently established in the British fiscal system. At first it took the form of a flat rate (it fell to 2d in the £ in 1874), though a certain measure of progression was in effect secured by moderate exemptions at the lower end of the scale. In the present century two important modifications were introduced. In 1907 differential rates of duty were imposed on earned and unearned incomes, and in 1910 the principle of progression was extended by the introduction of a graduated sur-tax on the higher incomes in addition to the standard rate

The income tax has the advantage of elasticity, though recent events have demonstrated that the limits are being approached if not already reached. Secondly, it has a very high yield and is economical to administer. Thirdly, it conforms better than indirect taxation to the principle of equity, in that the tax can be graduated according to the ability of the taxpayer, and that appropriate exemptions and allowances can be devised.

Income tax, as already noted, can rarely be shifted Where it falls on dividends or on personal earnings, it is extremely difficult to move, either backward to the source of the income or forward to the purchaser of the goods or services. Where it is levied specifically on profits, the obstacles to passing it on are almost as great, for, as tax is not paid until there is a realized excess of revenue over expenditure, it does not directly affect the marginal firms, which, under competitive conditions, would tend to undercut the more prosperous firms if the latter attempted to raise their prices. The fact, too, that the effective rate of income tax and sur-tax varies with the amount of income makes it still more difficult for this form of taxation to be shifted

Death Duties

Estate duties, which are levied on capital amounts passing at death, have come to occupy an important part in the British fiscal system They have the merit, not only of yielding a large revenue to the Treasury, but of compensating for certain deficiencies and limitations in the system of income tax—

(*a*) Death duties are imposed on accumulations, some of which (e g. increases in the capital value of property) are not liable to income tax.

(*b*) They are levied upon wealth that yields a "psychic" as distinct from a money income (e g. furniture and art treasures).

(*c*) They make for a more equitable apportionment of aggregate tax burden as between earned and investment income receivers. People enjoying investment incomes are not under the same compulsion as those who depend on their own earnings to set aside during their lifetime large sums against a "rainy day," or for the maintenance of their dependants in the event of early death or incapacity. They are, therefore, free to spend a larger proportion of a given amount of income on current requirements.

Graduation of Death Duties.

Death duties may be graduated in a variety of ways—

(*a*) According to the value of the estate. This is the basis of the British estate duty, the rate increasing from 1 per cent on estates of £2,000–3,000 to 80 per cent on estates exceeding £1,000,000.

(*b*) According to the relationship of the successor Until 1949, when they were abolished, the British legacy and succession duties (varying from 1 per cent in the case of relatives in direct line to 10 per cent in the case of distant or non-related persons) yielded about one-eighth of the revenue from the estate duty. The latter duty was increased in that year so as to compensate for the loss of revenue from the former duties

(*c*) According to the amount of the specific inheritance.

(*d*) According to the wealth of the inheritor.

(*e*) According to the "relative age" of the estate. Sometimes known as the Rignano plan, this method would impose a comparatively low duty on the first time of passing, but higher rates on subsequent occasions Though more difficult to administer than the ordinary estate duty, it is held by its supporters to be more equitable and at the same time less prejudicial to accumulation by one's own efforts.

Taxes on Land and Land Values

The old land tax, the redemption and termination of which was provided for in the 1949 Budget, yielded less than £1 million in its later years Current forms of land taxation are provided under Schedules A and B of the income tax, relating to the ownership and the profits of occupation of land. In local rating, too, land is an important source of public revenue.

A tax on land must be distinguished from one on land values. Taxation of "unearned increment" due to pressure of a growing population on a limited area of land, or of "betterment" arising from public improvements and developments, has for long been an object of fiscal reform. Land value taxation was introduced in 1909, but was subsequently repealed. In 1931 a similar measure was passed, but its operation was very soon suspended.[1]

Where the tax is calculated according to the net rent of the land, it tends ultimately to be borne by the landowner, for reasons explained in Chapter XI Since marginal land theoretically bears no rent, the owners of supra-marginal land are precluded, according to the classical doctrine, from passing on the duty As previously noted, however, the practical application of the theory is not easy or straightforward.

Where the tax takes the form of a fixed annual charge, the manner and degree of shifting are governed by the general principles of incidence already outlined If the marginal landowner is affected as well as the others, the duty is almost certain to be passed on There is a certain tendency for such a tax to become capitalized when the property concerned changes hands. With the compulsory redemption of this tax, however, its incidence becomes of no more than academic interest.

Direct Taxation

The advantages and disadvantages of direct taxation in relation to indirect taxation may be briefly summarized as follows—

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[1] A more direct control over the use of land was established under the Town and Country Planning Act, 1947 Owners of land who wished to develop it were now required to obtain permission from the Local Planning Authority Development was held to comprise the carrying out of building, engineering, mining or other operations, or effecting a material change in use

(i) **Advantages.**

(*a*) The incidence of a direct is easier to determine than that of an indirect tax.

(*b*) Direct taxation can be made progressive, and so act in accordance with the principle of equity. This is generally impracticable in indirect taxation, except in so far as the taxation of luxuries, the consumption of which rises more than proportionately to incomes, affords a limited degree of progression.

(*c*) The cost of collection is comparatively low, especially as much of the tax is deducted at source.

(*d*) An increase in income automatically yields an increase in tax revenue.

(*e*) Within reasonable limits, direct taxation is elastic in its yield.

(*f*) The taxpayer knows exactly how much he pays.

(*g*) Direct taxation enables the State to reach those nationals who derive their income from the home country but live for a large part of the year in another. Similarly it is possible to exact some contribution from foreigners towards the revenue of the country in which their income originates.

(ii) **Disadvantages.**

(*a*) There is a greater possibility of evasion in direct than in indirect taxation. At one time it was alleged that the income tax was a "tax on honesty."

(*b*) The keeping of records and filling up of forms can be very laborious as against the comparative simplicity of indirect taxation.

(*c*) Payment of large sums at one time can be very inconvenient, though it is largely obviated by the system of deducting taxes at source both for dividend receivers and for salary and wage earners.

(*d*) A high income tax can be prejudicial to effort and enterprise, especially where, as in the case of overtime payments, it falls on "marginal" earnings at a relatively severe rate.

Indirect Taxation

The merits and limitations of indirect taxation have to some extent been indicated or implied, but may be more positively stated—

(i) **Advantages.**

(*a*) The taxpayer does not feel the burden so heavily when it is spread over many purchases throughout the year.

(*b*) Collection is comparatively easy.

(*c*) A tax on luxuries falls on the "surplus" element in incomes.

(*d*) Indirect taxation enables those with small incomes to be reached more effectively and economically.

(*e*) Evasion is more difficult than in direct taxation.

(*f*) To a certain extent indirect taxation is elastic. A tax on a necessary can be moderately increased or decreased, and the resultant revenue fairly accurately estimated. On the other hand a tax on a commodity subject to a variable demand might not be capable of much expansion. Thus an indirect tax is elastic (i e in the resultant revenue) when the demand for the article is inelastic; and vice versa.[1]

(*g*) Where it is desired to check the consumption of a noxious article, a tax may have the requisite effect so far as comparatively poor people are concerned, but it would not materially reduce such consumption on the part of the well-to-do.

(*h*) Indirect taxation enables the State to derive some revenue from foreign visitors, who normally would be exempt from paying direct taxes.

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[1] The demand may prove to be so sensitive that an increase in tax may cause the total yield to diminish

(ii) **Disadvantages.**

(*a*) Indirect taxation is usually regressive in character, for, as one's income increases, the proportion taken in commodity duties perceptibly diminishes. Further, where the tax is specific, and not *ad valorem*, it is apt to be doubly regressive in that a poor person, who purchases a cheaper grade of article, pays a higher proportion in tax. For example, if the tax on tea were *ad valorem* it would still be regressive for the reason that the consumption of tea does not increase in proportion to one's income. But the fact that it is a specific sum per lb irrespective of price results in a still further disproportionate charge on the poorer consumers

(*b*) Where the demand for the article is elastic, the revenue is uncertain.

(*c*) The incidence is not always easy to determine.

(*d*) Indirect taxation can be comparatively expensive, not so much to the Treasury as to the wholesalers and retailers who have to lay out large sums and serve as unpaid tax collectors; and sometimes to the consumers in that prices may go up by more than the amount of the tax, especially where fractional quantities are involved

(*e*) It is harmful to industry when levied on an article that is used, not for "final" consumption, but for use in further production. Because of the interest to be paid on the larger initial outlay of capital, and other additions to "overheads," the cost of production is increased and the price of the finished product may be advanced out of all proportion to the original duty.

(*f*) Indirect taxation may be harmful to producers and consumers in general in so far as it disturbs the marginal equilibrium between taxed and untaxed commodities.

Section 2. Local Taxation

Local and National Taxation Compared

Particulars of the main forms of revenue and expenditure of local authorities in recent years are given in the table on p. 297 The proportion obtained in the form of Government grants has steadily increased, and now roughly equals that derived from the rates. With this increase has come a corresponding central control over local expenditure.

It is unnecessary to enter here at length into the economics of local finance, as the basic principles are similar to those governing public revenue and expenditure in general. Certain differences, however, in the administration of national and local finance may be noted—

(i) When money is raised within a narrow area, and is spent in providing a local service, the relationship between payment made and value received is usually more direct and definable than it is in national finance. In this connection a distinction is sometimes drawn between "onerous" and "beneficial" services. The former, such as education and poor relief, are as much of national as of local advantage. The latter, such as drainage and street lighting, result in special benefit to local property owners and occupiers. Some contend that the costs of the "beneficial" services should be locally defrayed, and those of the "onerous" services borne by the State. Usually, however, national and local advantages are so interwoven as to be indistinguishable, and the distinction, even if it were just, would be practicable to only a limited extent.

(ii) Whereas national taxation rests on a comparatively broad basis and is adjusted according to a number of criteria (e.g. income, estates, consumption, etc.), local rates are governed almost entirely by the value of occupied property, whether it be houses, land, factory or other business premises. In national finance property has been found to be an inadequate criterion of ability to pay In local finance its deficiencies have also been proved, and reliefs to certain types of occupiers as well as to entire localities have been found necessary. By the Act of 1929, industrial premises were "de-rated" to the extent of 75 per cent; a similar concession was granted to the transport industries, while agricultural property, already relieved to some extent, was exempted altogether.

In recent years, however, with the marked increase in the rate burden and the greater prosperity of industrial undertakings in general, there has been a call for revision of the discrimination in favour of industrial premises In 1957 the degree of exemption was reduced from 75 to 50 per cent.

LOCAL AUTHORITIES' CURRENT REVENUE AND EXPENDITURE[1]

Main Items
£ million

	1946	1949	1952	1955	1958
Total Revenue	643	737	931	1,189	1,670
Grants from Central Government	243	286	369	469	635
Rates	269	326	393	476	645
Trading income[2]	44	23	23	29	42
Rental income[2]	79	94	137	206	207
Total Expenditure	643	737	931	1,189	1,670
Police	27	36	48	56	79
Education	173	236	318	410	587
Health	73	44	53	59	79
Roads	56	63	75	91	111
Sewerage, etc	30	37	44	54	78
Debt interest	61	66	98	155	258
Surplus[2]	70	81	83	104	144

[1] *National Income and Expenditure* (Central Statistical Office), 1956–9

[2] Before providing for depreciation and stock appreciation

Grants-in-Aid

Grants-in-aid are the contributions from national funds to local authorities. Local services and development schemes are matters of national importance, and for the ratepayer to bear full responsibility for the cost is both undesirable and impracticable. While local authorities are entitled to ask for financial help from the central government, the latter is equally justified in watching over and checking the outlay of such bodies, and the assistance given is almost invariably subject to the observance of certain conditions.

The case for grants-in-aid rests on a number of grounds—

(i) They are justified when a local authority engages upon development work of national importance.

(ii) They are necessary where the local body is incapable financially of carrying out its proper functions.

(iii) They provide a stimulus to local authorities who might be backward or unwilling.

(iv) They helped to reduce the inequality of burden as between one district and another—particularly as regards the cost of alleviating poverty and distress, the causes of which are by no means localized, and the relief of which has come to be recognized as a national responsibility.

(v) They are necessary to give weight to the suggestions, criticisms and instructions of the central authority, which is naturally more experienced than smaller authorities in anticipating and providing for public needs.

(vi) They are the means of enforcing on local authorities the "national minimum" of efficiency so necessary in the public interests.[1]

Incidence of Local Rates

Although the principles governing the incidence of local rates are essentially no different from those which determine the incidence of taxes in general, the problem of determining the ultimate liability for the rates is more complicated—

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[1] See S and B Webb, *Grants-in-Aid*

(*a*) Because of the number of parties involved. Though the rates are levied upon the occupier, they may be shifted backward to the building owner (and perhaps to an intermediate leaseholder) and eventually to the landowner, or, in the case of business premises, forward to customers or clients

(*b*) Because of long-term leases common in the letting of properties, and the difficulty during their period of making adjustments consequent upon a change in the rates.

(*c*) Because of the slowness of production and consumption of building properties, and the persistence for long periods of monopoly conditions.

The factors determining the apportionment among the principal parties may be briefly noted—

(i) **The Landowner.** As shown in Chapter XI, economic rent does not enter into price, which tends to approximate to the cost of the production at the margin where there is no pure rent. Thus, a tax or rate intended to fall on economic rent could not, in theory, take the form of an addition to price. In practice, however, the whole burden does not always reach the landowner, partly because the ratio of pure rent to gross rental may be negligible, partly because it may be impracticable to separate the various items in the gross payment, and partly because of the frictional forces already noted.

(ii) **The Building Owner.** It is only because of the peculiar conditions attaching to the production of buildings that special considerations of incidence, as affecting the owner, arise. Rates may increase or diminish from year to year, but the owner, different from a seller of other commodities, cannot quickly adjust his supplies to changing circumstances. Within a limited period the building owner is in a similar position to the landowner, and may have to bear part of the rate burden. The same applies to leaseholders during their term of responsibility.

(iii) **The Occupier.** Under certain conditions the rates on the occupier of business premises may be shifted backward to the building owner or to the landowner. More usually, however, they move forward to the purchaser of the goods made or sold in the rated premises. It is not always possible, however, to transmit the whole of the burden, especially where the price is largely determined by firms that operate in comparatively lightly-rated areas. As for private dwelling houses, since the opportunity of shifting the burden in a forward direction is rarely present, and since backward shifting is seldom practicable, the rates in almost all cases remain, as is the intention, a direct charge on the occupier.

Effects of Local Rates

The principles governing the effects of taxation in general may be applied with little qualification to local rating. The main reservation arises from the selection of property occupation as the sole criterion and basis, in consequence of which a number of peculiar problems arise.

Reference has already been made to the shortcomings in the methods of assessment as between one type of property occupier and another. Local rating is essentially regressive in character. The charge is apt to be inequitable not only between householders with different incomes, but also between occupiers of different types of business premises. "Heavy" industries that need more space and buildings than "light" trades and vocations may be required to pay a disproportionately high rate. Similarly the ratepayers in a depressed area, notwithstanding the grants from the central exchequer, may be burdened with heavier rates than those in a more prosperous locality.

For many years rates continued to be levied according to pre-1945 valuation lists In the meanwhile relative values, especially as providing a basis for equitable assessment, underwent a considerable change In 1956 a revaluation on a national scale came into force Although the poundage rate was reduced at the same time, it did not, as a rule, decline in proportion The burden on commercial and trading establishments in particular was greatly increased. Some easement, however, was afforded by a further revision in 1957, coupled with the increased percentage noted on p 297, to be imposed on industrial premises [1]

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[1] Among the various proposals for reform is the introduction of a local income tax on a limited scale The assessments already made by the Inland Revenue could provide the basis and reduce administrative costs An argument against a local income tax is that, in the absence of an adequate equalization grant, it would operate very unequally between one authority and another, especially between the thickly populated urban centre and the suburban or rural areas

CHAPTER XXI

PUBLIC DEBTS

Non-tax Revenue

It is normally a rule of public finance that ordinary expenditure should be met as far as possible out of current revenue As a rule, taxation is depended upon to provide the required income, but where conditions are abnormal, such as in war time, resort may be made to—

(*a*) Currency inflation ,
(*b*) Sale of national property ;
(*c*) Loans.

(*a*) As shown in Chapter XIII, currency inflation leads to depreciation in the purchasing value of money. The higher prices that have to be paid for goods and services are tantamount to a forced levy on the people If all incomes were equal, such depreciation would hit everybody alike and be little different in its effects from an evenly applied tax But, as incomes vary considerably, the burden of inflation, in the manner of a proportionate tax, falls more heavily on those with smaller incomes. The economic and social effects may be serious, even disastrous, as is evident from the experience of a number of countries in recent times.

(*b*) In special circumstances the realization of nationally owned property may provide needed funds During the 1939–45 war the British Government disposed of substantial holdings of American securities which it possessed or controlled.

(*c*) Funds to provide for other than current expenditure are usually obtained by borrowing. The present chapter will be mainly concerned with the nature of public debts, national and local, and with the methods ordinarily employed for their financing and eventual reduction.

Short- and Long-term Loans

A government may resort to short-term borrowing even though its annual income is more than adequate to meet its expenditure. Tax receipts do not come in regularly throughout the year, and there are periods when the outgoings are greater than the income. At such times the government raises loans for short periods, usually at a very low rate of interest. In this country short-term loans are obtained from the money market by means of Treasury Bills, and from the Bank of England in the form of "Ways and Means Advances." Such a procedure is normal and unexceptionable, but when temporary loans are effected for reasons other than short-term deficits, and are repaid from the proceeds of fresh loans, they are open to question—unless, of course, new money is borrowed at a relatively low rate for paying off an existing debt which involves a higher charge

If a government is in need of large capital amounts, and short-term loans are unsuitable or unprocurable, it may have recourse to long-term borrowing. For this it has to pay a higher rate of interest, since the risk may be greater and the lenders require compensation for tying up their capital for perhaps a number of years Should it prove necessary to incur abnormally large expenditure, such as arises in time of war, long-term loans become practically unavoidable.

Real Burden of National Debt

The real burden of a National Debt depends on a number of factors—

(*a*) *The purpose of the loan* Where capital is borrowed for the acquisition or extension of productive undertakings the economic return may balance or exceed the interest payments Where the debt is the result of war borrowings there is no such compensatory source of revenue.

(*b*) *The extent of home and foreign holdings* Where the debt stock is held by the country's own nationals the payments involve internal transferences and so prove less burdensome to the nation as a whole than where they are made to foreign stockholders.

(*c*) *The period of the loan.* Long-period loans at fixed interest rates are liable to increase the burden on the taxpayers and confer a benefit on the stockholders if prices decline, and conversely if prices rise.

(*d*) *The distribution of wealth and income* A large part of the debt stock is owned by a comparatively small proportion of the people Taxation, though on a progressive basis, is not so concentrated as the ownership of government stock In recent years, however, the levelling influence of income tax and death duties has been very marked, while the ownership of public stock has become more dispersed.

The British National Debt

The British National Debt is due almost entirely to wars. At the end of the Napoleonic wars it amounted to about £700 million. In 1914, after a century of comparative peace, the figure was approximately the same. Four years of war increased the National Debt to £8000 million The second world war was even more costly. Despite the fact that a higher proportion of the expenditure was obtained from taxation, the national indebtedness rose to above £24,000 million, and in the immediately post-war years increased to over £25,000 million, mainly on account of the American loan. By 1958 the annual cost to the taxpayer amounted to about £700 million, representing about 4 per cent of the national income, as compared with just under 1 per cent in 1913.

The following table shows the growth and composition of the internal and external debt in recent years.

NATIONAL DEBT[1]
at 31st March
£ million

	1947	1950	1953	1956	1959
TOTAL NATIONAL DEBT of which	25,734	25,802	26,051	27,038	27,376
Total Funded Debt (Consols, Consolidated Loan, War Loan, etc)	3,903	3,899	3,866	3,809	3,748
Total Unfunded Debt—Internal (Exchequer Bonds, Funding Loan, National Defence Loan, War Bonds, Savings Bonds, Terminable Annuities, Defence Bonds, National Savings Certificates, Treasury Bills, etc)	21,050	19,798	20,101	21,228	21,514
Payable in external currencies	767	2,190	2,162	2,075	2,186

[1] *Annual Abstract of Statistics*

The actual burden of the National Debt has not in fact increased to the extent which the above figures might suggest. Apart from the above general conditions determining the net burden, account should be taken of the decline over the years in the purchasing value of the pound, and at the same time of the overall increase in the national income Following the war of 1914–18 the National Debt represented 175 per cent of the total income. The ratio subsequently declined, but the war of 1939–45 caused it to rise to 200 per cent Since then it has again diminished, and in 1959 was less than 150 per cent

The real burden of the debt, however, is not the capital sum but the current charge. During and immediately following the first world war the rate of interest on government loans rose to over 4 per cent During the second world war the rate was more effectively controlled, and averaged little more than 2 per cent. The policy of cheap money was continued in the immediately following years. The sharp rise in interest rates in 1954–57 increased the cost of new borrowings, but the decline in these rates in 1958–59 eased the situation, and permitted of a certain amount of conversion into stock bearing a lower charge.

External Debt

The above considerations apply primarily to the internal debt. The external debt, though much smaller, can be a serious drain on the country's resources. Britain's external debt was negligible before the first world war, but after 1918 the United States became a large creditor. Eventually Britain found that she was unable to keep up her payments, particularly as several of the late belligerent nations which owed large sums to this country had virtually defaulted.

During the second world war the United States supplied many goods to Britain on "lend-lease" terms, but subsequently waived the financial claims. Shortly afterwards new loans were contracted with the United States and Canada The dollar loan proved to be less enduring and helpful than had been anticipated, partly because of the urgent needs of the United Kingdom and partly because of the rise in prices in the United States. The rapid exhaustion of this loan helped to precipitate the economic crisis of 1947, to which fuller reference is made in the following chapter.

In addition Britain incurred debts to various countries on account of goods and services provided during the war Thus India and Egypt acquired considerable sterling credits, the liquidation of which had to be very carefully liquidated The debt to the Argentine was largely paid off by the sale in 1947 of the British-owned railways, though this meant the end of an important invisible export.[1]

Reduction of the National Debt

The following methods of reducing the national debt are employed—

(*a*) *Application of the surplus annual revenue* This is perhaps the simplest method, but is necessarily limited in operation. The possibility of any surplus is always liable to evoke a cry for a reduction in the rate of taxation, although an already realized surplus is automatically applied to the cancellation of debt. The Chancellor of the Exchequer may deliberately budget for a surplus, as much with the object of "mopping up" excessive spending power in order to counter inflation as with the reduction of debt.

(*b*) *Redemption by purchase of stock.* When Government stock is available on the market at a comparatively low price, the National Debt Commissioners may enter the market as buyers, and thus redeem a certain amount of stock. The extent of such transactions naturally depends on the relative rates of interest on cancelled stock and fresh borrowings.

(*c*) *Conversion* Conversion into stock bearing a lower rate of interest is an important means of reducing the real debt charge. Government loans are ordinarily for a given term, and if at its expiry new money can be borrowed at a lower rate, the holders of these loans are given the alternative of accepting a lower interest or the repayment of the principal. For instance in 1932 nearly £2000 million worth of 5 per cent War Stock was converted to a 3½ per cent basis. Subsequently other conversions took place at a still lower rate.

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[1] For a full account of the National Debt and its management see the Radcliffe Report on the Working of the Monetary System, 1959, Chapter VII

(*d*) *Terminable annuities.* By this means permanent is converted into temporary debt. Annuities are provided through the Post Office or from Chancery funds, and interest is paid for a definite period or a lifetime. The rate of interest is higher than the ordinary rate on the debt, but, when the payments cease, so much debt has been redeemed These annuities, however, have not proved very popular, and the amount of public debt thus liquidated is not considerable.

(*e*) *Sinking funds.* The principle of a sinking fund, stated shortly, is to provide out of income a certain sum of money so calculated that, invested at compound interest, it will accumulate to the amount required by the time the loan is to be redeemed In 1939 the proportion of debt funded in this way amounted to nearly one-half. During the subsequent war the unfunded debt greatly increased As is shown in the table on p 305, the ratio of funded debt in 1956 was below one-seventh of the total National Debt.

Debts of Local Authorities and Public Corporations

Besides the debt of the central government account has to be taken of the borrowings by the local authorities and the public corporations (transport, coal, electricity, etc) The table on p 309 shows that the total indebtedness in each group amounted in 1958 to about £5,500 million, of which a large proportion represented loans from the central exchequer Allowing for these and other self-balancing items, the aggregate public debt was about £31,000 million.

Local borrowings from the public usually involve the issue of stock, which, being backed by tangible assets and secured upon rates and revenue, find a ready market among investors Or they may take the form of mortgages on its property, bank loans and bills.

DEBTS OF LOCAL AUTHORITIES AND PUBLIC CORPORATIONS[1]

at 31st March

£ million

	Local Authorities (Great Britain)		Public Corporations	
	Debt to Exchequer	Other Debt	Debt to Exchequer	Other Debt
1952	1,817	1,126	480	2,871
1954	2,495	1,394	663	3,094
1956	3,126	1,681	900	3,597
1958	3,210	2,390	1,796	3,616

Local debts incurred for capital purposes are required by the Government to be redeemed within a period not exceeding the estimated life of the assets to be created. The usual way of paying off the debts is the sinking fund method described above Other ways are fixed instalments of the principal sum with diminishing interest payments on the balance, and fixed annual payments, covering principal and interest, for the whole term of the loan.

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[1] *Report of (Radcliffe) Committee on the Working of the Monetary System,* 1959

PART VI

THE CHANGING ECONOMY

CHAPTER XXII

INTER-WAR AND POST-WAR CHANGES

DURING the present century profound changes have taken place in the national and international economy, to some extent influenced and accelerated by two world wars Along with the material developments in the pattern and technique of industry and trade significant advances have been made in social conditions and standards.

Changes between the Wars

(*a*) *Change in Britain's relative position* With the economic development of foreign countries during and following the first world war Britain's relative position in the world economy became weaker While her foreign trade tended to contract, her dependence on exports in order to procure food and raw materials grew more pronounced

(*b*) *Change in the general character of production.* With the gradual recovery in income and standards of life, a larger proportion of labour and resources than before was devoted to the production of luxury and semi-luxury articles and services. The market for such products was not so stable or predictable as that for the major necessaries of life.

(*c*) *Incomplete rationalization* As competitive production by comparatively small units was giving way to various forms of combination and rationalization, it became possible to avoid overlapping and waste and to co-ordinate related economic activities In certain large industries, however, the rationalization was not carried far enough to ensure, in times of depression, adequate control over output and prices, and when, for some reason, a link in the chain gave way, the repercussions were liable to be all the more severe and widespread.

(*d*) *Over-supply of primary products.* In the 'twenties and 'thirties there was a world-wide improvement in the methods of producing foodstuffs and raw materials, due largely to mechanization and to scientific techniques, but the world's effective demand for these products did not show a corresponding increase The demand for a number of primary goods was often insufficiently responsive to price changes, and suppliers, where conditions permitted, sometimes resorted to deliberate restriction of output

(*e*) *Spread of trade restrictions.* During the same period, tariffs in all parts of the world were raised, and the scope of these duties greatly extended. Subsidies, controls, and sundry other forms of regulation, had similarly restrictive effects The consequences for countries such as the United Kingdom, which depended very largely on foreign supplies and markets, were especially serious.

The Crisis of 1931

The above factors contributed in varying degree in bringing about the crisis of 1931. Events in that year moved quickly and, so far as they concerned the United Kingdom in particular, may be briefly reviewed

(*a*) *Decline in British exports, and adverse balance of trade* The British export industries and services were greatly embarrassed by the deteriorating world conditions, and the balance of payments became less and less favourable from year to year. By 1931 it was evident that, for the first time in recent history, an adverse balance would be experienced. The rate of exchange was naturally affected, and, in the circumstances of the time, a drain of gold was the inevitable consequence.

(*b*) *The Budget deficit.* The national finances were seriously affected by the depression Tax revenue on the one hand tended to shrink, while expenditure in certain directions, notably in maintaining a growing body of unemployed, greatly increased. A Government Committee, which had been set up to explore the possibilities of reducing public expenditure, put forward some drastic recommendations at a time and in a manner liable to cause apprehension about Britain's financial position. Many foreign creditors feared that the Budget could not be immediately balanced by taxation, and that the Government would resort to inflation, the outcome of which could not be predicted As subsequent events proved, this apprehension abroad was not justified. By a supplementary Budget in the autumn of 1931 measures were adopted to make good the deficit Taxation was increased and reductions in certain forms of expenditure were announced.

(*c*) *Reactions abroad* Foreign uncertainty was by no means confined to the United Kingdom's position alone. Indeed, it was not until several failures and defaults had occurred in Europe and other parts of the world that the situation of Britain came to be regarded as dangerous, and it was partly her own actions in endeavouring to assist the financially stricken countries that led her into difficulties. British banks, having made long-term loans to Germany and Austria, found themselves short of funds when foreign depositors began to withdraw their funds

(*d*) *Suspension of the Gold Standard.* Once the run had started, and it was feared that there was an insufficiency of funds to meet all demands, the pressure of foreign creditors became intensified The stocks of gold in London fell to an extremely low level Credits were obtained from the central banks of France and the United States, but they proved inadequate to stem the rush, and in September, 1931, six years after the return to the gold standard, the United Kingdom was compelled once more to suspend gold payments.

The decision meant that the central bank was relieved of its obligation to deliver gold against legal tender. Gold exports, therefore, ceased and the foreign exchange rate promptly fell. The decline in the rate of exchange penalized importers, who now had to pay more English money for foreign goods, but gave a certain respite and even stimulus for a while to exporters, who could obtain better prices in home currency for their wares sold abroad. Similarly, manufacturers, who had been suffering from foreign competition in the home market, gained a temporary relief. These benefits, however, could continue only so long as other nations remained on gold Most of them in fact soon followed Britain's lead, if only as a measure of self-protection [1]

Recovery: 1932–39

Due largely to world movements as well as to measures at home, conditions in the United Kingdom showed a marked recovery from 1932 onwards. World production was increasing and unemployment diminishing. While the improvement was attributable in part to general rearmament (though recovery based on this was hardly well based) it arose also from a growing demand for consumers' goods in general and indirectly for capital goods over a wide field There was a marked expansion in the building and automobile trades, and in the new industries producing radio sets, synthetic materials and plastic goods

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[1] The United States suspended gold payments in 1933, but resumed them in the following year with a depreciated dollar equivalent to 60 per cent of the original amount of gold

The increase in production, however, was due in some degree to improvements in technological and labour-saving methods, employment therefore, though it expanded, did not grow at the same rate. Furthermore, the recovery was not uniform all over the world, but was mainly confined to particular regions and countries. International trade and shipping seriously lagged behind the increase in production.

Among the special characteristics of this period may be mentioned—

(*a*) *The spread of economic nationalism.* The desire for self-sufficiency, however uneconomic this might be as judged by normal standards, led to an intensification of tariffs and subsidies, together with other devices for fostering industry. The short-run effects were undeniably to increase the volume of employment, but this did not necessarily imply a corresponding improvement in the general standard of living

(*b*) *The growth of armaments.* Bound up with (*a*) was a greater activity in the production of armaments, which benefited in particular the heavy industries, while bringing orders to numerous ancillary trades. The effects in other directions, however, were far from beneficial, owing to the diversion of economic resources, and to the heavy taxation that rearmament entailed

In 1937–38 a set-back occurred. While normal cyclical forces were partly responsible, they were accentuated by political factors Early in 1939 there appeared signs of economic improvement in certain countries, but the international situation stood in the way of any general advancement. Progress was definitely halted by the outbreak of hostilities in September of that year

The Second World War: Diversion of Industry

In terms of human casualties the war of 1939–45 was not so catastrophic for the United Kingdom as the war of 1914–18 The economic effects, however, were in some ways more serious The physical destruction caused by air attacks was far more severe than in the previous war, and the drain on the nation's reserves and material resources more exhausting

The leading changes in the economic and social structure during the second world war may be briefly outlined—

(*a*) *Expansion of war industries.* Armaments and other goods for the war effort were produced in unprecedented quantities. The engineering and similar industries were greatly expanded So also were agriculture and a number of food-producing industries.

(*b*) *Contraction of less essential industries* Heavy restrictions were imposed on industries and services that were not considered essential to the war effort The consumer goods industries, except for those providing the necessaries of life, and the distributive trades in general were especially affected by the cuts in material supplies and the withdrawal of labour

(*c*) *Direction of labour* A modified form of industrial conscription was introduced early in the war. This unprecedented step was rendered necessary by the extreme urgency of the military situation and the grave shortage of manpower Under the Essential Works Orders, employees in a number of industries and services were prohibited from giving up their employment except by the permission of the authorities.

(*d*) *Concentration of production* Schemes of concentration were put into force in a large number of industries, which included some essential as well as the less essential trades. Firms were required to join with others in "nucleus" groups, and concentrate their individually restricted production in a smaller number of establishments

(*e*) *Relocation of industry* The transferences of activities of absorbed firms under the concentration scheme were mainly within the same region Movements on a much larger scale took place partly as a result of, or as a precaution against, enemy attack In addition many new Government-sponsored factories were established in the Midlands, the North of England, Wales and Scotland

(*f*) *Industrial controls* Under the Limitation of Supplies Orders, as well as under other regulations, supplies of materials and other goods were controlled on a quota basis. A machinery licensing system was instituted.

(*g*) *"Utility" production.* In order to make the fullest use of the limited supplies of labour, material and equipment, many consumer goods (e g. clothing, footwear, furniture) were required to conform to prescribed specifications A certain degree of standardization was introduced. As part of the general scheme the prices of the "utility" products were rigidly controlled.

(*h*) *Price controls* The prices of other types of goods were kept in check, either by direct control or through Price Regulation Committees. Rents of houses below a certain figure were "frozen" at the pre-war level

(*i*) *Rationing.* Control of production and prices could not of itself ensure smooth distribution and fair allocation of goods in short supply. Hence a comprehensive scheme of food and clothing rationing was introduced. The sale of petrol was also strictly regulated.

(*j*) *Subsidies.* In order to safeguard living standards and counter the persistent tendency towards inflation the Government introduced subsidies on many foodstuffs and articles of clothing and footwear

(*k*) *Increased taxation and borrowing.* To meet the costs of the war, and to "mop up" surplus spending power, taxation was considerably increased. The income tax rose to 10s in the £ Profits in excess of a peace-time standard were, beyond a certain level, subjected to an excess profits tax of 100 per cent. Commodity taxes were correspondingly increased In addition, substantial loans were raised, abroad as well as at home.

(*l*) *Financial controls* The financial mechanism was rigorously controlled. The rate of interest was kept low in pursuance of the "cheap money" policy New capital issues were ordinarily forbidden Private holdings of foreign investments were in many cases compulsorily purchased in order to realize them abroad and reduce Britain's indebtedness

(*m*) *Adverse balance of trade.* Britain's trade balance greatly deteriorated, largely because of the severe contraction of exports, both visible and invisible Total exports fell at one time during the war to under 30 per cent of the 1938 volume, recovering to 45 per cent in 1945. Imports were also curtailed, but not in the same degree; in 1945 they represented about 60 per cent of the pre-war volume.

Reconversion: 1945-47

The national economy was so disrupted by the war that reconversion proved inevitably slow and difficult

(*a*) *Contraction of war industries.* The number of factories and employees engaged on munitions and the like greatly diminished, though not to the pre-war level.

(*b*) *Re-expansion of contracted industries* With the gradual removal of a number of restrictions and the revival of consumer demand, the industries which were contracted during the war were gradually rehabilitated.

(*c*) *Labour supply.* The war-time powers of labour direction were soon withdrawn, but the Essential Works Orders remained in force for certain trades until 1947.

(*d*) *De-concentration of production.* The process of de-concentration presented many complexities Many of the absorbed firms which desired to resume their independence (as most of them did) experienced difficulty in recruiting labour, obtaining materials and regaining premises.

(*e*) *Relocation.* While most firms that had migrated returned within a short time to their pre-war premises, many chose to remain in their new location, either because their former buildings had been destroyed or diverted to new purposes, or because of the attractions of the district in which they were now settled Numerous Government-sponsored factories, particularly in the "development areas," were converted to peace-time uses. They were intended to be a means not only of preventing unemployment in these districts, but of helping to bring about a better distribution of industry over the country as a whole.

(*f*) *Lifting of controls* With the ending of hostilities a number of the controls on materials and machinery were lifted

(*g*) *Continued "utility" production.* Shortages of material and labour compelled the retention of "utility" specifications for clothing and other necessaries, but austerity conditions were gradually relaxed

(*h*) *Price regulation.* Owing to continued shortages, the prices of many goods were still regulated by authority, as were also the rents of houses. The danger of inflation was still present, and tending to grow.

(*i*) *Continued rationing.* The persisting scarcity of many articles of food and clothing made it impossible to dispense with rationing.

(*j*) *Increased subsidies* Owing to the cessation of "lend-lease" supplies from the United States, and to the rise in world prices, the cost of the food subsidies in the two years following the war more than doubled.

(*k*) *Modified taxation and borrowing.* The 1946 Budget reduced income tax to 9s in the £ and abolished the excess profits tax from the end of that year. Some slight reductions were made in commodity taxes. Borrowing continued but the cost to the Exchequer was eased by the maintenance of the "cheap money" policy.

(*l*) *Relaxation of financial controls.* Certain of the war-time controls governing financial operations and new capital issues were relaxed. The influence of the Treasury over the money market generally was maintained

(*m*) *The drive for exports.* In order to pay for the necessary imports of foodstuffs, raw materials and other commodities, a determined effort was made to increase the volume of exports, even though home consumers had to go short of urgently needed goods.[1]

The Crisis of 1947

The economic situation in this country, as well as in many parts of Europe, gave special cause for anxiety in 1947 The persisting difficulties of post-war readjustment were aggravated by a hard winter, widespread floods, subsequent drought and poor harvests

The United Kingdom suffered from a series of crises in that year. The opening months witnessed a marked deficiency in coal production, accompanied by a serious inadequacy of electric generating plant. The fuel shortage caused serious interruptions in industrial areas, and many factories that depended on public power supply closed down or went on short time.

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[1] In 1931 the Macmillan Committee had drawn attention to the need for new institutions which would provide credit for a period normally too long for the banks, but too short for new-issue financing through the Stock Exchange To fill the gap there were established in 1945 the Finance Corporation for Industry, Ltd (F C I) primarily for the benefit of major undertakings, and the smaller Industrial and Commercial Finance Corporation, Ltd (I C F C) for the assistance of more modest enterprises The Bank of England provided 30 per cent of the capital of the former Corporation, and made a token investment in the latter In 1953 the Commonwealth Development Finance Company, Ltd , was formed in order to assist suitable projects in the Commonwealth and Colonies

In the middle of the year the foreign exchange position became acute. The gap between Britain's exports and imports grew wider. Convertibility of sterling into dollars had been restored, but so heavy were the subsequent drawings on sterling that after a few weeks the restrictions had to be reimposed. The dollar loan was all but exhausted, the small remaining part was temporarily "frozen" To help pay for Britain's essential imports substantial drafts were made on her gold reserves.

In the course of the year several measures were adopted in an attempt to overcome the difficulties:

(*a*) *Restriction of imports.* A number of restrictions that had been withdrawn since 1945 were revived, and several new limitations, especially on goods coming from "hard currency" areas, were introduced. Tobacco and cotton imports were temporarily stopped A heavy duty on imported cinema films tantamount to prohibition was imposed

(*b*) *Extended rationing.* The reduction in food imports, coupled with shortages in home production, made further rationing inevitable The consumption of bread, potatoes, bacon and sugar was reduced, and that of petrol for private motoring was prohibited.

(*c*) *Intensified export drive.* The export effort was accentuated. Targets were set for a wide range of industries producing both consumers' and capital goods, and exporting firms were given a measure of priority in supplies of labour, materials and equipment.

(*d*) *Labour supply.* Despite the claims of defence, heavy cuts were made in the fighting services and the supply industries, thereby releasing large numbers for productive employment Working hours in a number of industries were temporarily increased Restrictions on immigration were relaxed and about 100,000 European workers were given employment.

(*e*) *Material and capital controls* Several war-time controls of raw materials and capital equipment were continued or re-imposed, and price regulation over a wide field was maintained New capital issues continued to be subject to scrutiny before approval Many schemes involving large capital expenditure, public as well as private, were curtailed or postponed.

(*f*) *Financial measures* Large earnings and profits and reduced supplies for the home market conspired to bring about an inflationary situation To combat this the Government intensified the National Savings campaign and raised the level of taxation. Commodity duties were augmented over a wide range. New taxes, such as those on company profits and on betting, were introduced. A number of subsidies, chiefly affecting clothing and footwear, were withdrawn Measures such as these went some way towards stopping the gap, but still there was "too much money chasing too few goods"

Partial Recovery, 1948-50

The dangers which had threatened in 1948 were largely averted, due in great measure to an intensified production drive and a continuing restraint on consumption and partly to assistance from the United States under the European Recovery Programme.

Progress was made in 1948–50 in a number of directions—

(*a*) *Production* Industrial output, which accounts for about a half of the national income, rose by 8 per cent in 1948. The table on p. 322 gives the indices, based on 1948, in the subsequent years. Total industrial production is shown to have risen by 6 per cent in 1949 and a further 8 per cent in 1950. Increases by more than the average were recorded in the output of vehicles, chemicals, paper, textiles, engineering and electrical goods, etc. Industries whose output rose by less than the average included mining, building, metal manufacture, drink and tobacco.

INDEX OF INDUSTRIAL PRODUCTION, 1949–1957[1]
Average 1948 = 100

	1949	1950	1951	1952	1954	1955	1956	1957
Total all industries	106	114	117	114	130	137	137	138
Total manufacturing industries	107	116	121	116	133	142	140	143
China and earthenware	105	109	114	108	109	110	99	99
Glass	107	113	122	105	117	136	137	133
Bricks, cement, etc	104	111	115	121	131	132	132	128
Ferrous metal manufacture	104	109	113	117	125	134	138	141
Non-ferrous metal manufacture	94	102	116	116	117	131	124	121
Engineering, shipbuilding, electrical goods	106	116	127	127	140	155	151	156
Vehicles	111	121	124	124	155	172	160	165
Other metal goods	100	105	113	111	111	125	123	116
Precision instruments, jewellery, etc	107	110	113	100	123	126	120	122
Chemicals and allied trades	109	124	135	133	168	179	185	192
Textiles	108	118	119	96	117	115	115	114
Clothing	109	115	111	105	114	118	121	120
Leather goods and fur	101	103	97	86	96	96	91	92
Food	106	112	108	114	126	124	128	128
Drink and tobacco	100	98	99	98	100	106	108	113
Manufactures of wood and cork	113	122	127	115	145	147	140	143
Paper and printing	115	133	140	118	155	169	167	169
Other manufacturing industries	103	117	123	111	139	153	148	159
Mining and quarrying	103	104	108	109	110	108	109	109
Building and contracting	105	105	101	104	115	116	123	123
Gas, electricity and water	107	116	124	127	145	153	160	163

(*b*) *National income* The gross national product rose from rather less than £9,500 million in 1947 to more than £11,500 million in 1950, an increase of about 23 per cent. During the same period retail prices rose by 14 per cent (See tables on pp. 111 and 204)

(*c*) *Manpower* Releases from the armed forces enabled the industrial population to increase by 300,000 in 1948, bringing the total number in Great Britain to about 22¾ million. The figure rose very little in the following years The fact that the working population increased by slightly more than 1 per cent points to the more than proportionate increase in productivity per head, though this rate of improvement was excelled in America and many European countries. Further particulars of man-power are given in the table on p 338, which also shows its distribution among the various industries and services. Unemployment amounted to 1½ per cent in 1948–50 and was even less thereafter.

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[1] *Annual Abstract of Statistics*, 1958 (The *Annual Abstract*, 1959, contains the figures for 1958 and recalculates the indices on the basis of 1954 = 100)

(*d*) *Capital formation* The amount set aside for fixed capital formation increased from £1,200 million in 1947 to £1,700 million in 1950, i e. by about 42 per cent. The actual increase, allowing for price changes, was about 27 per cent. (For figures of gross capital formation, see p. 30.)

(*e*) *Derationing and decontrol* With the steady improvement in supplies the scheme of rationing was gradually abandoned In 1948 the emergency rationing of bread and potatoes came to an end, and free sales of footwear were permitted. In 1949 clothing and household textiles were derationed. With the general rise in prices the purse was becoming as important as the ration book in governing demand, and the liberation of the market was not followed by such heavy purchases as had been thought possible

Progress was made also in freeing industry and trade from the manifold controls and regulations. Restrictions on the purchase and sale of numerous materials and capital goods were lifted, and the procedure for obtaining permits and licences, where still necessary, was simplified.

(*f*) *Balance of payments* In 1946–47 the balance of trade was very unfavourable. By 1948, however, following a 25 per cent increase in exports as against only 4 per cent in imports, the scales were just turned. But for the fact that, owing to rising world prices, the terms of trade for this country were deteriorating, the improvement would have been more considerable.

£ million

	Average 1935–38	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958
Imports											
Total	887·2	2,278·8	2,609·4	3,904·5	3,477·9	3,343·4	3,373·9	3,883·7	3,886·1	4,070·8	3,779·5
Food, beverages and tobacco	398·3	966·6	1,026·2	1,291·6	1,206·1	1,315·2	1,325·9	440·5	1,448·8	1,494·0	1,506·4
Basic materials	249·5	727·3	910·7	1,522·5	1,145·4	1,054·7	1,025·5	1,123·9	1,103·1	1,168·6	907·9
Mineral fuels and lubricants	42·6	149·1	197·0	315·7	338·6	313·5	328·9	1,408·2	413·7	465·7	440·8
Manufactured goods	191·9	414·7	458·9	759·8	768·4	642·8	679·4	896·3	906·0	927·4	908·7
Semi-manufactures	132·2	308·9	350·3	627·9	572·9	438·0	504·9	679·8	658·2	640·5	586·5
Finished manufactures	59·7	105·7	108·6	131·9	195·5	204·8	174·5	216·5	247·8	287·0	322·2
Exports of United Kingdom Products											
Total	465·1	1,789·1	2,174·2	2,581·9	2,584·7	2,582·1	2,674·2	2,905·4	3,171·5	3,324·4	3,208·0
Food, beverages and tobacco	34·4	95·8	132·9	158·3	155·5	150·3	158·3	172·0	182·8	206·2	193·7
Basic materials	27·7	50·2	89·3	108·5	82·1	96·9	101·2	111·4	115·9	123·0	109·0
Mineral fuels and lubricants	42·1	70·0	77·1	69·8	125·5	147·6	152·2	141·4	161·9	152·7	133·2
Manufactured goods Total	347·7	1,526·4	1,827·4	2,195·6	2,141·7	2,098·3	2,171·8	2,387·7	2,619·9	2,754·1	2,687·5
Metals	62·2	220·0	262·8	270·4	317·3	341·4	339·0	396·3	441·5	476·9	431·8
Engineering products	93·4	666·2	799·6	915·7	993·5	971·1	1,013·7	1,118·2	1,269·9	1,354·7	1,397·7
Textiles (excluding clothing)	107·1	322·3	360·1	468·3	334·8	325·5	324·4	310·6	295·2	301·6	255·1
Other	85·0	317·9	404·9	541·2	496·1	460·3	494·6	562·7	613·3	620·9	602·9
Re-exports	62·7	58·0	84·7	127·0	143·9	105·5	100·7	118·9	146·4	133·5	147·4

CURRENT BALANCE OF PAYMENTS[1]

£ million

	1949	1950	1951	1952	1953	1954	1955	1956	1957	1958
Balance of Current Transactions										
Total	+ 38	+ 297	— 419	+ 227	+ 179	+ 211	— 73	+ 237	+ 263	+ 455
Visible trade	— 131	— 136	— 749	— 128	— 219	— 195	— 356	— 55	— 58	+ 120
Invisibles (net)	+ 169	+ 433	+ 330	+ 355	+ 398	+ 406	+ 283	+ 292	+ 321	+ 335

In the early part of 1949, however, there was danger once more of a serious deficit, owing to heavy dollar expenditure by the sterling countries and a decline in dollar earnings At the same time a temporary recession in the United States led to a contraction of American purchases of goods in the sterling area.

(g) *Devaluation* In an attempt to curb the heavy drawings on the gold and dollar reserves restrictions were imposed by the United Kingdom and most Commonwealth countries on all but the most urgent purchases from the dollar area. The drain, however, continued and in six months the reserves fell from $2,000 million to $1,340 million.

In September, 1949, the pound sterling was devalued by slightly more than 30 per cent to a rate of $2.80 to the £ Many other countries, which had been in a similar situation, revalued their own currencies accordingly

The devaluation was followed by a marked improvement in the balance of payments. The actual position was obscured to some extent by the Marshall Aid payments from the U S A. to the United Kingdom and the grants from the latter to other countries

The recovery was due partly to a revival of American demand, partly to the continuing restrictions on imports from dollar countries, and partly to the larger exports which the devaluation had helped to make possible. In reality, however, a larger volume of goods had now to be sent abroad to pay for a given quantity of imports. Because of the increased cost of imports from dollar areas, prices in this country inevitably went up, though, owing to stocks in hand and the time taken for converting materials into finished goods, the impact on the consumer was not immediate.

The improvement in 1950 was sufficient to warrant the suspension of American aid under the European

Recovery Programme. In 1951, however, Britain experienced a further setback. Again measures were taken to check imports and domestic consumption, and the reserves, which had fallen by over £500 million, rose again.

Although the balance of payments gradually became more favourable, certain reservations had to be made. First, most of the recovery took place in the sterling area. The deficit with the western hemisphere was still very considerable. Only the credits from the U.S.A. and Canada, together with the E.R.P. payments, made it possible for this deficit to be met without drawing substantially on gold and dollar holdings. Secondly, there were distinct signs that the sellers' market for many goods was giving place to a buyers' market, and that British manufacturers in a number of industries would experience greater difficulty in selling their products abroad.

Changes in the Economy, 1950–57

Some idea of the general developments in the national economy from 1950 may be obtained from the tables in the preceding pages.

(*a*) *Comparative production* As shown on p 322, the index of industrial production rose, on the reckoning of 1948 = 100, from 114 in 1950 to 138 in 1957. On the average the output increased annually by about 3·5 per cent as compared with 3 per cent in the early years of the century During 1955–57, however, the index did not show any marked improvement.

The rate of increase in industrial production since 1950 has compared favourably with that in North America, but has been exceeded elsewhere, notably in Western Germany, Japan, and the U S S.R The following table gives a broad indication of the rate of growth in the leading countries.

WORLD INDUSTRIAL PRODUCTION, 1950–59[1]
1953 = 100

	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959 (Sept)
World	83	92	94	100	100	111	116	120	117	—
United Kingdom	94	98	94	100	108	114	114	116	114	122
U S A	84	90	93	100	93	104	107	107	100	112
Canada	85	92	94	100	99	107	115	120	117	127
W Germany	72	85	91	100	112	129	139	147	152	162
France	89	99	98	100	109	117	128	139	154	160
Italy	78	89	91	100	109	119	12[illegible]	138	141	157
Belgium	93	106	101	100	106	116	123	123	115	119
Sweden	95	100	98	100	104	111	115	119	120	122
Netherlands	88	91	91	110	110	118	124	126	126	139
Latin America	91	96	98	100	108	118	125	134	136	—
Japan	55	74	82	100	108	117	144	167	169	—
U S S R	69	80	89	100	113	127	141	155	170	—

[1] *National Institute Economic Review*, Jan , 1960

(*b*) *Fuel and power.* The rate of increase of industrial production is naturally dependent on supplies of fuel and power.

FUEL AND POWER PRODUCTION, 1938–58[1]
Great Britain

	1938	1946	1949	1952	1955	1958
Coal—million tons	227	190	215	226	222	216
Gas—million therms	—	2,239	2,490	2,754	2,901	2,865
Electricity—million kWh	25,708	43,984	50,168	63,493	81,447	99,612
Petroleum from refineries and distillation plants—thousand tons—						
Aviation and motor spirits	306	487	899	4,852	7,220	6,751
Gas and diesel oils	632	448	1,208	3,792	4,474	6,285
Fuel oil (excluding refinery fuel)	344	427	2,317	10,295	10,776	12,572

[2] Ministry of Power

The above table shows that the coal produced in 1958 was only one-sixth more than in 1946, and was slightly less than in 1938.[1] While the production of gas rose by one-third between 1946 and 1958, that of electricity, which is gradually reducing its dependence on coal, more than doubled The supply of electricity will be further extended as the new atomic energy stations, of which the first was opened in 1956, come into operation.

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[1] In 1959 the National Coal Board announced its intention to close down a number of uneconomic mines

The growing importance of oil as a source of power is clearly revealed Production of motor spirit and gas and diesel oils was twelve times greater in 1958 than in 1946, while between 1946 and 1958 that of fuel oil increased thirty fold.

(*c*) *The trade balance* The improvement in Britain's position in 1950 was followed by a set-back in 1951, due largely to the Korean War and the deterioration in the terms of trade. The table on p 324 shows that the adverse balance of payments in 1951 exceeded £400 million, but that the balance became favourable again during the succeeding years. The deficit with the dollar countries, however, persisted, and the limitations on purchases from these sources were kept in force.

(*d*) *Financial policy* In order to free resources for markets overseas and curb the inflationary conditions at home the restrictions on domestic demand were intensified. Purchase taxes were increased and hire-purchase regulations were made more stringent As part of the "credit squeeze," the Bank rate was raised in stages, reaching 5½ per cent in 1956 A temporary improvement permitted the rate to fall to 5 per cent early in 1957, but a renewed deterioration in the autumn caused it to be put up to the exceptionally high level of 7 per cent.

General Recovery, 1958–59

The years 1958–59 witnessed important development in the national economy and public policy. During the first part of 1958 the current surplus on the balance of payments rose to a record height, the reserves greatly improved, prices became more stable, and the volume of savings increased Investment, however, did not keep pace, and output and employment showed a certain decline.

In order to stimulate demand a number of measures were taken, in the reasonable belief that, against the changed economic background, neither the external finances nor the level of prices need be endangered—

(*a*) The Bank rate was reduced to 6 per cent in March, 1958, and by further stages to 4 per cent in November.

(*b*) The control over bank advances was lifted in July, 1958, and the restrictions on new capital issues were eased

(*c*) Public investment was authorized on an increased scale, notably on roads, railways and housing

(*d*) Hire-purchase dealings were freed from restrictions.

(*e*) The regulations requiring the consent of the Capital Issues Committee to the raising of new capital were almost entirely abolished.

(*f*) The Budget of 1959 brought reductions in the income tax and many commodity duties, extended the scale of investment allowances, and provided for a more rapid repayment of post-war credits

Although the national economy markedly improved throughout 1959, the recession persisted in a few areas In Lancashire a special scheme of compensation from the Exchequer resulted in the closing down of many redundant plants and the transference of resources to more productive employment. Measures for encouraging new industrial projects in needy localities were foreshadowed.

The index of industrial production, which had remained stationary from 1955 to 1958, rose by over 8 per cent in 1959. Unemployment which had approached 3 per cent early in the year fell to under 2 per cent. After some years of inflation the retail price index kept fairly steady around 109.

The growing strength of the pound, helped by the favourable terms of trade, had made it possible in 1958 to make sterling partly convertible into dollars, and to ease restrictions on certain dollar imports In 1959 the list of goods which could be freely imported from the U.S.A and elsewhere was greatly extended. Sundry other concessions, including the restoration of virtually unlimited travel allowances, were further pointers to Britain's economic recovery.

Expansion of Social Services

Since 1950 there has been a marked expansion of the public social services. As is shown in the table on p 331, the total outlay by the central and local authorities has steadily risen from £1,500m to £2,700m. Of the total outlay on these services, rather less than half is accounted for by money payments to persons, the remainder comprising the provision of goods and services and of benefits in kind.

(*a*) *National Insurance and Assistance.* A large proportion of the cost of National Insurance is met out of workers' and employers' contributions Of the total expenditure of £775m in 1957–58 these contributions accounted for £670m

The cost of National Assistance, amounting to £150m in 1957–58, was borne entirely by public funds About half of this consisted of payments to old persons, usually as a supplement to pensions, and a fifth to sick persons, exclusive of sickness benefits under the Insurance Scheme.

(*b*) *Retirement Pensions.* The cost of retirement pensions, apart from national assistance, already exceeds £500m, and is certain to become greater as the age distribution changes. As was shown in the table on p. 22 the proportion of persons over 64 is likely to rise from about 12 per cent at the present time to 15 per cent within 20 years. On this reckoning, and disregarding possible changes in retirement ages and in the cost of living, it is estimated that the cost of pensions will more than double in this period.

CURRENT EXPENDITURE ON SOCIAL SERVICES BY ALL PUBLIC AUTHORITIES, 1949/50–1957/58[1]

United Kingdom
Years ended 31st March
£ million

	1949/50	1952/53	1954/55	1957/58
Total Expenditure	1,529	1,917	2,109	2,694
National Insurance—Total —including	441	527	567	775
Retirement pensions	254	320	353	489
Sickness benefits	68	82	88	116
Unemployment benefits	21	30	18	29
Non-contributory Old-age Pensions	29	24	20	16
National Assistance	66	121	135	150
Family Allowances	65	93	112	131
Nutrition Services .	64	80	80	83
Education .	299	390	454	646
National Health Service	419	477	512	647
Housing	69	87	105	110

[1] *Annual Abstract of Statistics*, 1956–9

In this connexion account should be taken of private superannuation schemes, which in 1955 provided pensions amounting to about £150m. These schemes, which qualify for important tax concessions, are rapidly expanding. Legislation in 1956 made it possible for self-employed persons, hitherto at a disadvantage in providing for retirement, to obtain a substantial tax allowance on premiums.

Partly because of the prospect of rising costs of pensions, and partly because of the general improvement in health and physique and the consequent extension of working capacity beyond the age formerly associated with retirement, consideration has been given to the raising of the standard age qualifying for State pensions. In 1955 a government committee recommended that the age should be raised by three years to 68 for men and 63 for women

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[1] In 1959 proposals were announced for graduated pensions according to earnings, coupled with suitably graded contributions

From other quarters it has been proposed that pensions should be differentiated according to age, or that the present provisions for compensating elderly but physically able persons who continue work for a period beyond the statutory age, should be made more generous.

(c) *National Health Service* A large part of the National Health Service is concerned with preventive as distinct from ameliorative functions, and is of high economic as well as social significance. The cost of this service is met in the main from general taxation.[1] Of the total expenditure about 60 per cent goes on hospital and specialist services, about 12 per cent on general medical services, 9 per cent on pharmaceutical services and 6 per cent on dental services. In all, the scheme employs over 500,000 people, of whom about three-quarters are engaged full time.

(d) *Education* The remaining large item in the scheme of social services, involving an outlay of £650m, is education Approximately three-fifths of this cost is met by the Treasury and the balance by the local authorities, apart from the expenditure on the universities, which are now largely financed by government grants, and the schools maintained from private funds. The educational services altogether employ nearly 700,000 persons.[2]

(e) *The Social Services and the Standard of Living.* Though the considerable advance in recent times in the general standard of living has been primarily due to the increase in national production, it is partly attributable to the extension of social services It was estimated in 1955–56 that the benefits in money and kind were equivalent to over £3 per family per week, averaging £1 7s. 6d in respect of insurance and assistance payments and family allowances, 17s health services, 16s 6d. education, and 3s. housing subsidies, to which could be added 6s 6d. for food subsidies not included in the table Apart from the reduction in food subsidies the comparative situation in 1959 was much the same. Over the period the beneficiaries have themselves helped to finance the scheme by insurance contributions and taxes, but an important part of the cost has been met from general tax revenue.

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[1] The contribution from the National Insurance Fund was increased from one-fifteenth to one-ninth in 1957

[2] If, to the number of persons employed in the nationally owned undertakings and public services, are added the 130,000 engaged in central and local government administration (see table on p 338) the total approaches 6 million out of a total working population of 24 million Inclusion of the armed forces would bring the aggregate to over 6½ million

CHAPTER XXIII

PROBLEMS OF ADJUSTMENT

Section 1. *Adaptation and Reorganization*

THOUGH the disturbances and dislocations caused by two World Wars have been largely overcome, the international situation has not permitted of a return to normal economic conditions The necessity to maintain defence forces on a considerable scale and to spend unprecedented amounts on armaments in peace time imposes a continuing strain on the national economy. Were it not for the new discoveries in science and technology, and for new methods of organization for utilizing existing resources to greater effect, it is questionable whether the standard of living would have been maintained, let alone improved The change in Britain's relative position makes it all the more essential to take full advantage of the new knowledge and techniques.

Structural Change

Attention has been focused in recent years on the quality of organization, especially of the older industries in which the progress has been far from uniform. The factors governing productivity have already been described, but may be briefly restated in the light of current developments

(*a*) *Structure and size.* The structure of a number of industries and the constituent firms has not kept pace with modern requirements Where the products have to compete in the international market with those of younger but rapidly developing countries, the disadvantage can be very marked. Establishments and plants over a large part of British industry are too small or inadequately organized to permit of high efficiency. This does not necessarily imply that the factory must be extensive or that the scale of operation must be very large. It is possible in a number of industries to secure optimum results in units of modest size Conversely there are many large undertakings which fail to take advantage of the economies of size and scale

(*b*) *Re-equipment* The rate of re-equipment since the end of the war has been very uneven. In view of the high costs of new plant, aggravated sometimes by delays in delivery, many manufacturers have found it more expedient to renovate or modify their existing machinery In some industries, such as cotton, which have suffered from a diminished market, the reluctance to replace old, but still usable and adaptable, equipment is understandable, but enterprising manufacturers have demonstrated that, even under these conditions, the introduction of up-to-date machinery, though costly, may be fully justified by the results.

The comparative slowness in re-equipment, however, is not wholly attributable to the manufacturers. In certain industries, organized labour, in its desire to maintain wage standards or prevent unemployment, has been partly responsible. Another factor is the high rate of taxation of profits, coupled with a scale of allowances for depreciation and obsolescence which, despite recent concessions, is generally considered inadequate to meet the high costs of replacement.

(*c*) *Automation* The system of automatic machine control, usually based on electronic devices, extending over an entire series of operations, is being increasingly employed in the engineering, electrical, chemical and other industries. In offices, too, mechanical computers, which do the work of many routine clerks, are gradually gaining ground So far these methods are feasible only where the scale of activity is large enough to justify the very expensive installation, but it is reasonable to suppose that, as in the history of earlier inventions, lower costs will lead to a wider adoption.

(*d*) *Management* To cope with the changing conditions in industry and employment new types of managers are required While the possession of technical qualifications is an increasingly important attribute as new machines and techniques become introduced, there is a growing need for suitably trained managers to deal with the many personal problems that arise in the relations with labour.

(*e*) *Deployment of labour.* Closely bound up with economic organization in general and with industrial management in particular is the promotion of labour efficiency. Several reports have appeared in recent years on the productivity of British labour, especially in relation to American standards More than one mission has drawn attention to the lower production per man-hour (P M H.) in a large sector of British industry[1] To a large extent this is attributed to differences in investment in capital equipment per head It is due also to differences in the quality of organization and management and in the intensity of the workers' effort

Consideration has been given in recent years to the practicability of redeploying labour with the object of increasing its productivity This has been prompted as much by a shortage in numbers as by a deficiency in quality. Redeployment is but a special form of rationalization They both denote a more efficient use of available resources and a more intensive specialization of labour.

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[1] With the object of informing managements and workers in certain industries of new methods and techniques, the Anglo-American Productivity Council was formed in 1948 Under its auspices several British delegations paid visits to American factories, and issued instructive reports on the relative methods of production

It is in some of the older industries that the need for redeployment of labour is most insistent. In some of the textile trades, for instance, in which labour has become scarce, it has already been possible, by rearranging the duties in several sections, to raise output considerably without overloading the operatives. The greater productivity has made possible an appreciable increase in earnings Traditional practices in these trades, coupled with long-established uniform wages lists, have to some extent proved an obstacle. Where the systems of redeployment have entailed the use of stop-watch and similar devices for regulating labour and fixing rates of pay, and where the workers still fear a recurrence of unemployment, their suspicions and apprehensions can be understood. But under sympathetic management and with the provision of safeguards these objections lose much of their force.

Manpower

Problems of manpower supply arise more from an unbalanced distribution between different occupations than from an overall shortage Some of the main present-day factors may be briefly noted.

(*a*) *Distribution of labour force.* The table on page 338 gives the number of persons employed in the different industries and services in Great Britain in recent years Besides throwing light on the size of the various primary and secondary industries it reveals the extent of a number of "service" trades, notably in distribution, which have greatly expanded in recent years Although an increase in the number and proportion of people in the service trades normally reflects an enlargement of the national income and the standard of living, the rate of growth of certain of these occupations is apt in some quarters to be viewed with concern. There were practically 3 million people

DISTRIBUTION OF MANPOWER IN GREAT BRITAIN, 1948–1959[1]

June in each year
Thousands

	1948	1952	1954	1956	1958	1959
Total Working Population	22,780	23,294	23,667	24,107	24,070	23,968
Males	15,657	15,864	15,974	16,188	16,160	16,063
Females	7,123	7,430	7,693	7,919	7,910	7,905
H M Forces and Women's Services	846	872	839	761	614	565
Total in Civil Employment	21,569	22,119	22,604	23,149	23,080	23,020
Males	14,549	14,836	15,009	15,310	15,288	15,234
Females	7,020	7,283	7,595	7,839	7,792	7,786
Agriculture, forestry and fishing	1,178	1,112	1,074	1,032	1,009	1,000
Mining and quarrying	876	875	867	858	854	824
Manufacturing industries	8,137	8,626	8,976	9,269	9,147	9,110
Building and contracting	1,450	1,435	1,453	1,541	1,492	1,496
Gas, electricity and water	321	372	373	376	375	374
Transport and communication	1,787	1,759	1,715	1,730	1,705	1,673
Distributive trades	2,484	2,616	2,743	2,870	2,939	2,961
Professional, financial and miscellaneous services	3,954	3,988	4,077	4,173	4,258	4,300
Public administration—						
National Government Service	682	606	594	561	529	519
Local Government Service	700	730	732	739	772	782
Registered Unemployed						
Wholly unemployed	273	295	218	191	370	394
Temporarily stopped	9	120	12	39	62	17

[1] Ministry of Labour.

engaged in distribution in 1959 The number in the retail and wholesale trades had risen by 50 per cent between 1924 and 1939, and although it declined considerably during the war it recovered thereafter to a greater extent than had been contemplated.[1] There were more than 1¼ million persons in national and local government service (excluding the armed forces), though a large proportion of these consisted of manual workers in the public undertakings, apart from those separately listed.

Very significant is the figure of nearly 8 million female workers, including a large number of married women, out of a total labour force of 24 million. The ratio is inflated because of the inclusion of many part-time workers, but even so it is considerably higher than it was before the war. Despite the shortage of labour in certain trades, there is anxiety in some quarters lest the employment of married women should be carried to extremes, having regard to the trend of the birthrate and the long-term population needs of the nation.

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[1] For the growth in the numbers employed in retail trade see table p. 53 note

(*b*) *Population and age composition* The total labour force in recent years has increased at a far greater rate than the aggregate population. As was shown in Chapter II, the number of the people is tending to become stationary and eventually to contract. To some extent, though not necessarily in proportion, the labour force is bound to follow suit. What is more serious from the economic standpoint is the steady rise in the average age and a decline in the number of people in the normal working age groups Such a decline need not, of course, imply a fall in production and living standards, provided that labour-saving devices are sufficiently employed, that appropriate methods of organization and management are introduced, and that greater emphasis is placed on improving the quality of available labour.

(*c*) *School-leaving and retirement ages.* The raising of the school-leaving age accentuated for a while the shortage of young workers, which was already acute in many industrial areas. Though the long-term benefits of an extended period of school education were incontrovertible, certain trades were temporarily embarrassed.

The movement for lowering the pensionable age, however desirable it might be on humanitarian and social grounds, could beyond a certain point be detrimental to the national output. There is much to be said for encouraging people, in suitable cases, to continue working for a short period beyond the statutory pensionable age, since the average man of 65 to-day is physically better able to undertake a further spell of employment than was his predecessor of like age. The retirement pensions scheme does in fact contain certain provisions for voluntary postponement and appropriately increased payments at a later stage.

(*d*) *The burden of defence.* The industrial manpower situation is aggravated by the necessity of maintaining large numbers (about 550,000 at the end of 1959) in the armed forces, drawn very largely from those age groups which could make the most important contribution to national production. The maintenance of extensive armament industries, and of the many trades serving them, involves a hardly less costly diversion of human as well as physical resources. The decision in 1957 to reduce the size of the forces and to terminate compulsory service helped to bring about a better balanced distribution of labour.

Finance and Trade

In the field of finance and trade, domestic and foreign, many critical issues have to be faced. A particularly exacting problem is the extent of public expenditure that can be afforded from the national income. During and immediately following a war, government expenditure must necessarily be high, but its continuance on a large and increasing scale several years later gives rise to apprehension and misgiving. The proportion taken by the State has, of late, amounted to about 33 per cent of the national income, as compared with less than 25 per cent in the United States, and smaller percentages elsewhere.[1]

Another problem, largely bound up with taxation, is that of maintaining the necessary level of savings and investment. The increase in gross capital formation in recent years, as shown in the table on p. 30, has been appreciable, but the net formation, after allowing for depreciation, has proved inadequate to the need. In 1958 the nation had to depend on companies for about two-fifths of the gross capital formation, the remainder being provided by individuals, public authorities and corporations Prior to 1949 private savings had been a minus quantity. The improvement in the following years was partly due to the National Savings campaign, which was strengthened by the introduction of Premium Bonds in 1956 Basically it was attributable to the gradual recovery in the national economy.

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[1] It may be recalled that much of the public expenditure represents an internal transference The ratios of actual consumption of goods and services currently produced are considerably less than the above figures

The maintenance of the balance of payments must continue to be a prominent feature of British policy. The drive for exports, especially to dollar areas, must be maintained, while imports must be kept under control. Some relief is expected from colonial and other development schemes, which should perform the dual service of supplying Britain with a larger part of her food and material requirements, and of providing a dollar reserve. Such schemes, far from being incompatible with continued purchases from dollar countries, may help to bring forward the time when trade can be resumed on a more normal pattern.

Intimately bound up with the problem of the balance of payments is that of the sterling liabilities. These were largely created during the war in respect of supplies and services provided by allied and neutral countries. The sterling balances at the end of 1945 amounted to £3,694 million, of which about two-thirds were owing to countries in the sterling area In order to prevent a disastrous drain on Britain's resources, the balances were necessarily "frozen," repayment being allowed only in exceptional circumstances Much of the permitted repayment (to India and Egypt, for example) gave cause for anxiety, in view of the heavy "unrequited" exports and the adverse effects on the balance of payments By the end of 1958 the sterling debts to countries outside the sterling area had fallen by about a half to £700 million, while the amount owing to sterling countries had risen by one-sixth to £2,600 million.[1]

Section 2. Problems of a Mixed Economy

The middle of the twentieth century witnessed not so much a re-orientation in public policy as a stage in the consolidation of forces that had been gaining in momentum over a number of years. Though the current movements have been accelerated and given point by political changes they go deeper than purely party issues. In this closing section the leading elements and problems in the present-day mixed economy may be reviewed

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[1] The problems of adjustment in the financial mechanism and monetary policy were exhaustively considered in the Report of the Radcliffe Committee, 1959

(*a*) The Committee believed that the economy of the United Kingdom in the 1960's would prove to be more like that of the 1950's than of any earlier period, though possibly the world economy might not expand so rapidly and the demand for capital in the private sector might not be so strong (para 486)

(*b*) They maintained that, while changes in the rate of interest should not be made more drastic, the public authorities should not leave it to be determined by market forces, but must have a positive policy (para 492) They "should not aim at complete stability of interest rates, but should take a view as to what the long term situation demands and be prepared by all means in their power to influence markets in the desired direction" (para 498)

(*c*) Since "the banks are in a uniquely strong position to defeat, or at least to embarrass, any policy of the authorities in influencing rates of interest, there must be some restraint on the (banks') activities" The restraints already provided by the two liquidity requirements, the 8 per cent cash and 30 per cent liquid assets, "should be made absolutely explicit" (para 505) Otherwise special restraints on bank lending should not be imposed unless they were also imposed on other financial institutions "Since we envisage the use of monetary measures as not in ordinary times playing other than a subordinate part in guiding the development of the economy, we do not consider such an elaborate extension of compulsory powers to be justified in the conditions immediately before us" (paras 508–11)

(*d*) Capital issues control was not regarded "as a significant measure for influencing the total pressure of demand" and should not normally be employed" (para 512) Hire purchase controls "have the advantage of securing a sizeable and rapid impact on total demand, but this is a once-for-all effect, which tends quickly to disappear" The authorities should ordinarily be reluctant to use these controls (para 513)

(*e*) In emergency conditions other monetary measures might be employed, though by themselves they were liable to prove insufficient To meet the danger of headlong inflation, resort might be made to control of capital issues, and restrictions on bank advances and hire purchase The notion of some statutory limitation on the supply of money was rejected (paras 520–527).

Decline of Laissez-faire. For purposes of simple exposition, as a preliminary to a fuller examination of the economic system, various assumptions had to be made in the earlier chapters. Prominent among these was the notion of values based on supply and demand, which were supposed, in a *milieu* of competition, to adjust themselves to each other more or less automatically. The main justification of the price system was (and to a large extent still is) that it serves as a guide to producers and consumers and as a mechanism for bringing about equilibrium. The doctrine was commonly applied not only to the valuation of ordinary commodities, but to the determination of personal incomes.

For a while, in the evolution of modern society, anything which interfered with the operation of competitive forces was regarded as frictional, whether it arose within the system itself (such as an agreement between producers to circumvent the market) or whether it was applied from without (such as State regulation to prevent undue exploitation). Although intervention by the public authority was accepted as inevitable in certain circumstances, general policy was to keep it to the minimum.

In the course of time the so-called frictional elements became so numerous and powerful as to alter the very character of the national economy. Though *laissez-faire* was still regarded by many as an ideal, its shortcomings in practice came to be generally recognized and the authoritarian element steadily grew in strength.

The State has increasingly used its power, directly and indirectly, in the redistribution of incomes. The scope of wages legislation has been extended, and by means of subsidies and social services the effective minimum has been raised. As shown at some length in the previous pages, the proportion of the national income paid in wages and salaries has greatly increased in recent times, while the net amounts paid in profits, interest and rent have been severely restricted.

Hitherto the system of production has not been subject to the same degree of control as the incomes arising from it. The common assumption appears to have been that if the Government contented itself with regulating incomes after they had been produced, either by means of wages legislation or by differential taxation, the mechanism of production would in general continue to operate. But as the transferences increased, and the taxpayer became more concerned with what was left to him than what he originally received in gross amount, this assumption lost much of its validity. Even when the economic system was less subject to public regulation than it is now, high taxation proved often to be inimical to enterprise and effort. With the strengthening of the authoritarian element and the growing use of taxation and the publicly controlled financial mechanism as instruments of policy, the negative effects on individual productivity became increasingly evident.

Private and Public Sectors. So long as the means of production remain in private hands and the industrialist and investor are given reasonable freedom in the employment of these resources, the various regulations and controls, hampering though they may be, are unlikely of themselves to result in any fundamental change in the economic system as a whole. It is when the State acquires possession or full control of large sections of the country's economy that the problems of a mixed economy become acute. Though politicians may declare that it is their intention to nationalize only specified industries, apprehension among the remainder may well arise. Whether justifiably or not, firms in the "free" sectors may fear that their exemption is only temporary, and, if this view became widespread, new investment and development might be seriously retarded.

Conceptions of the scope and methods of nationalization by no means follow a uniform pattern. Though doctrinaire socialists may press religiously for the public ownership of all "the means of production, distribution and exchange," they do not in this country command wide support among their colleagues, let alone among the general electorate. Many socialists would be content with the public ownership of the primary and vital industries, leaving the secondary industries, though numerically in a majority, in private hands Some would seek control of all essential primary materials, through the allocation of which the industries depending on them could be to some extent regulated, though the conversion into finished goods remained in private hands. Some would take over part of the distributive trades, notably certain wholesaling activities, in order to reduce the high costs of getting the products to the consumer.

While a line might be drawn between one industry or service and another for purposes of immediate policy and legislation, it is questionable whether such a division could be effectively maintained for any length of time. Where nationally and privately owned industries are in competition for raw materials or equipment, whether home-produced or imported, the public undertaking is liable to be given some priority, though its claim is not necessarily more urgent. Where the State has acquired control of primary supplies or essential components, especially where these are purchased by government agencies, the bias is apt to be even more pronounced.

Cases of this kind have already been experienced in the provision of materials and equipment for the coal, electricity and other nationally-owned industries. The immediate needs of these undertakings may be so pressing as to justify this priority, and private businesses may in fact be the eventual beneficiaries. But unless provision is made for an impartial examination of the respective claims, it is by no means certain that the goods will be directed to those quarters where they will be used to the greatest advantage.

Kindred problems arise in the employment of personal skill—administrative, technical and professional—where the supply is insufficient to meet all public and private demands Short of actual direction of such labour which may be ruled out under normal conditions, the public body finds itself obliged to offer competitive salaries and conditions in order to secure the requisite staff.

Because of the extended functions of government, civil servants are being increasingly called upon to engage in commercial transactions, but since the number qualified to perform these services is limited, business executives are often brought in from outside at salaries higher than those ordinarily paid in the public services. Similarly, when the public health services were established, anomalies arose, not only between one section and another within the services (such as specialists and general medical practitioners) but between equally qualified people inside and outside the services (such as dentists in private and public practice).

In the exposition of the classical doctrine of value and distribution it was shown that the determining forces could best be observed at the margin. In a sense this would be true of the interplay of forces between the public and private elements in a mixed economy. But whereas in a free society the adjustment would be more or less automatic, in an authoritarian system deliberate action would be taken to prevent or rectify faults and anomalies In a mixed economy such marginal adjustments could be highly complex, and errors in judgment have wide repercussions.

Management and Incentives. The system of rewards and penalties which characterizes the capitalist system has been changing over many years. At the same time the relationship between the functions of organization and enterprise, hitherto undertaken by the same type of person, has greatly altered As producing units became larger and businesses more extensive, and as, in addition, the division between the risk-bearing functions of capital and the actual direction of the undertaking grew wider, the function of management acquired a new status. This did not necessarily imply a decline in the importance of enterprise as such, but rather a widening of the scope and responsibility of the factory manager and the business executive. Though the reward might still contain an element of profit, depending on the extent to which the two functions were combined, it increasingly took the form of a wage of management.

The emergence and strengthening of this important element facilitated the intervention by authority in certain economic activities, notably those which operated on fairly set lines and catered for a comparatively regular and assured demand. The men appointed to administer the schemes did not, as a rule, need the spur of profit or the fear of loss to induce them to give of their best If they had been previously employed in private industry they had in all probability relied for their livelihood on a salary rather than a profit, and to this extent their function and outlook underwent little change.

So long as the public authority is content to own and direct undertakings of this kind, the question of incentive need not present special difficulty It is when decisions have to be taken on new enterprises, in the literal sense, with all their risks and uncertainties, that the system of rewards may fail to evoke the requisite qualities. It is, for instance, one thing for a State to acquire a monopoly of a national broadcasting service but quite another to assume exclusive powers in the manufacture of radio receivers. Even within the sphere of broadcasting there is scope for healthy competition, as has been demonstrated by the advent of the independent commercial television services

For the supply of capital as well as of managerial ability the State is in a stronger position than was at one time considered likely. It has been shown that the rate of interest is by no means the sole factor governing the quantity of investment, even in a predominantly capitalist economy, and that in recent years the market rate has shown itself amenable to control. But even if the rate of interest were a more influential factor in private investment, it would not necessarily limit the amount of public capital, since taxation and other means at the Government's disposal can be used to curtail private expenditure and to compel saving And as the Government comes to own or control an increasing number of revenue-yielding undertakings, its power of acquiring capital and of either ploughing it back or transferring it to other employment grows in proportion

Labour Organizations. The position of the worker in the new economy has undergone important changes. The fear of unemployment is less formidable, and even if large numbers should be thrown out of work the provisions for insurance and assistance are a safeguard against undue distress. The social services in general have contributed towards a national minimum related to family needs, rectifying some of the crudities of the earlier wages system. Similarly, the attitude and functions of labour organizations have undergone a change. Trade unions in the early days were essentially defensive in conception and practice, and collective negotiation with the employers, whether they are private concerns or public departments, is still one of the union's primary activities. But with the growing equality of bargaining strength, coupled with the diminishing necessity, in view of the public social services, to provide friendly benefits for the members, the unions can now concentrate to a greater extent on their more positive functions.

The various restrictive practices of the trade unions have lost much of their earlier justification. After a century or more of mainly defensive action, however, it is difficult in a short space of time to bring about a complete change of attitude, with the result that unwarranted demarcations are frequently drawn and limitations on output are still imposed, notwithstanding a general shortage of labour and the vital necessity of increasing production. But there are signs that this negative policy is weakening. Within the factories progress has been made, in conjunction with managements, in the formation and conduct of works councils and committees. In the wider fields of industrial organization and political action the trade unions have extended their powers and assumed a greater responsibility.

The Social and Political Context. At the outset it was emphasized that economics is only one of a number of sciences concerned with man's behaviour in society. Economic considerations underlie many of his actions, but they are not the only impelling force. Even if it were possible to conceive of a society which was exclusively inspired and ruled by economic motives, the actual pattern could still show a wide variation. The essential problem is not one of a single *versus* a mixed economy, since all economies are, in fact, mixed in one degree or another, but rather of the degree and effectiveness with which the several elements are combined in a composite system

Though the authoritarian factor has been strengthened by recent political changes, it has been developing over a long period. With the swing of the party pendulum the growth of authority may have been accelerated or retarded, but the general trend has been unmistakable. The question for the near future is whether this trend will continue until the country's economy is predominantly in public hands, or whether before that stage a point of balance will be attained between the opposing forces; in other words, whether the mixed economy is to be regarded as merely a transitional stage, with large areas still in dispute, affording at best an uneasy compromise, or whether it can attain a degree of stability, enabling the different elements to co-operate in harmony for the common good.

International Factors. It need hardly be added that the economy of no country can be studied in isolation. This is particularly true of Britain which has built up her industry and commerce largely on a world basis. The conflict of ideas and policies which results in a mixed economy within a nation is even more evident, and can be more dangerous, in the international sphere. The world is tending to grow smaller as a result of technical advances in communication and transport At the same time the growth of economic nationalism has created barriers that tend to nullify this progress. Nations are torn between the two forms of development and the conflict is reflected in their internal economies.

It is not only in countries, such as Britain, which occupy a "middle-of-the-road" position that the opposing elements and resultant anomalies are to be found. In the United States, for example, the Government, despite the emphasis on free capitalism, has greatly extended its operation in the economic field, ranging from the undertaking of vast constructional works to the purchasing of surplus foods and materials at guaranteed prices. Conversely the Soviet Union, notwithstanding its communist ideology, has found it necessary to introduce a differential system of rewards in order to evoke the required individual effort. When countries which are popularly regarded as pursuing a single path are forced by circumstances to make concessions of this order, it is not surprising that societies occupying an intermediate position should be even less faithful to a single philosophy.

Offering some compensation for retrograde experiments in national self-sufficiency are some significant developments in international co-operation. Whether these are the results of external political pressure and the needs of defence, or are inspired by progressive forces from within, the repercussions on the economies of the participating countries can be very profound. The organizations for promoting economic co-operation in Western Europe and elsewhere may not only affect the territorial division of labour and the method of trade, but under certain conditions may even modify the system of political sovereignty. With the widening of the areas of responsibility the entire economic and political structure may be brought into closer accord with the needs of the modern world.

APPENDIX

THE DEVELOPMENT OF ECONOMIC DOCTRINE

ONLY in modern times has a serious attempt been made to study economics in its proper relationship to other social sciences. It was natural, with the great industrial and commercial changes in the eighteenth and nineteenth centuries, that people should grow more concerned with the principles underlying the economic system, and that thought should become more specialized. But long before economics achieved the dignity of a science its problems were occupying men's minds and rough generalizations, later to be reduced to more or less precise "laws," were being formulated.

The Early Period

The survey may begin with the early Greeks, among whom, despite the predominance of a small aristocratic class in the city-states, there gradually grew up a new class consisting of traders, who introduced a certain commercial spirit, and developed the monetary and credit systems in a way hitherto unknown. This gave rise to inquiry into the nature of money and, particularly, of interest. Thought was also stimulated on the question of slavery, by which system most of the production was then carried on. It was pointed out by more than one writer of the time that slave-labour was not necessarily economical; in effect, to use modern terms, that while the expense of such labour was low, the real cost might be high.

Prominent among the Greek social philosophers was

Plato, who in his "Republic" drew up a scheme for an ideal society, containing some noteworthy contributions to economic knowledge. *Aristotle* also is outstanding in this respect; his contention, for instance, that money was "barren," had a lasting influence on the attitude to the payment of interest. Other Greek writers were *Thucydides* and *Xenophon,* who dealt largely with the domestic aspects of economic life.

The Romans did not contribute much to pure doctrine. A small amount was written on husbandry. *Cicero,* however, voiced a common opinion when he deprecated trade, maintaining it was not a fit occupation for a true Roman.

It was not until the **Renaissance** that any serious attempt was made at economic theorizing, though this continued to be subordinated to religious and political considerations. The influence of Aristotle was still felt, and the deprecation of usury was due largely to his teaching Capital had not yet attained its full importance as a factor of production, and, since money borrowed was often put to a non-productive use, the medievalists could readily find reasons for denouncing the payment of interest. There developed, too, the popular conception of a "just price" for articles of sale. Medieval economy was largely in the hands of the gilds, which, particularly at first, had a strong religious and social element Among the medieval theorists on economic problems was *Nicholas Oresme,* who, in a work on money (1373), formulated the law relating to "good" and "bad" money, usually associated with Sir Thomas Gresham of a much later date *Copernicus,* too, wrote on monetary matters.

Until now English writers had not been very prominent, but the sixteenth century proved to be rich in economic philosophy as well as attainment. *Sir Thomas More,* in his well-known "Utopia," envisaged with remarkable prescience what was then regarded as an ideal community. The writings of *Francis Bacon* also comprised some valuable contributions to economic literature.

This was the period of great commercial expansion. The manorial had given way to a national economy. English traders were laying the foundations of the Empire, and the current economic writings contained many references to England's trade and maritime policy. Gradually there emerged the doctrine of **Mercantilism**, which dominated British economic activity for more than two hundred years. Mercantilism was the expression of nationalism in economic life, and showed itself in numerous forms. Exports were encouraged, and imports of many goods were subjected to heavy duties or forbidden altogether. Under the Navigation Acts attempts were made to capture the shipping trade and wrest economic advantage from the foreigner. The current doctrine was based largely on the false assumption that, in every exchange, if one party gains, the other must lose. This intense national economic feeling was not peculiar to England alone; in the seventeenth century it was characteristic of all the European States, particularly France and Prussia.

Thomas Mun (1621) was one of the principal exponents of the Mercantilist doctrine. He was followed in this country by *Child, Temple,* and *Davenant,* who confined their attentions mainly to foreign trade Other writers with a Mercantilist bias—though it gradually became less pronounced—were *Sir William Petty* ("Political Arithmetic," 1671), noteworthy as having employed statistical methods; *David Hume* ("Essays," *c.* 1752), a critic of the system in its more pronounced forms; and *Sir James Steuart,* "the last of the Mercantilists," whose

"Inquiry into the Principles of Political Economy" was issued in 1767, only nine years before Adam Smith's "Wealth of Nations."

The decay of gild regulation of industry and commerce was accompanied by a decline in the Mercantilist policy, which proved too narrow and restrictive for the quickening conditions of the eighteenth century. A reaction took place against Mercantilism, particularly in France, where the Physiocrats or *Economistes* promulgated the new doctrines. This school believed in a "law of nature," which was held to govern all man's activities and guide them to the common advantage The rule of free competition was supreme; any attempt at public intervention was considered harmful. The policy of "let alone," so popular in the eighteenth and early nineteenth centuries, found expression in the doctrine of *"Laissez-faire, laissez-passer."* What was good for the individual was proclaimed to be good for everybody; therefore remove the impediments to the full operation of the natural law, and let private enterprise have free play.

Chief among the Physiocrats was *Quesnay*, who is noted among other things for the stress he laid on the importance of agriculture, which was claimed to be the true source of all wealth. Manufacture merely changed the form of wealth, and commerce only distributed it. Land yielded a *produit net*, or surplus; industry and trade had no such quality. Quesnay's conception of the surplus from land foreshadowed Ricardo's theory of rent, and led to the proposal anticipating Henry George, for a single tax on land. The teachings of *Gournay*, another leading Physiocrat, were less narrow, in that they gave some recognition to the productiveness of industry and trade. Other members of the school were *Turgot* and *Cantillon*, who were interested largely in money, capital and public finance.

Discussion on the last subject was popular with all the Physiocrats, due doubtless to the crippling taxation in eighteenth-century France.

The Physiocrats performed a useful service in distinguishing economics from the other social sciences and in their application of scientific methods. They made useful contributions to the study of taxation and capital, and their emphasis on land and the derived surplus proved to be of great consequence.

The Modern Period

Modern theory is commonly said to begin with *Adam Smith,* an outstanding figure in the whole of economic literature. His "Wealth of Nations" (1776) presented the most comprehensive and constructive work that had yet appeared. In order to get a proper view of Adam Smith's teaching, it is necessary to take his other writings into account. In the "Theory of the Moral Sentiments" (1759), he dealt with social philosophy and general conduct. In the book upon which he was engaged when he died, he treated of law and politics. The "Wealth of Nations" was the intermediate work. The three together demonstrated from various aspects his belief in the "Invisible Hand" which controlled man's actions in this world. But his successors severed the practical conclusions from the larger context, and converted his broad philosophy into a doctrine of narrow individualism.

"An Inquiry into the Nature and Causes of the Wealth of Nations" served both as a title and as a definition of what Adam Smith considered to be the scope of political economy. Book I deals with "the causes of improvements in the productive powers of labour, and . . . the order according to which its produce is naturally distributed among the different ranks of the people." It considers, in turn, the division of labour, money, prices, wages profits and rent. In contrast with the Physiocrats Adam Smith attributed the source of wealth primarily to labour. Book II, embracing "the nature, accumulation and employment of stock," discusses the nature of capital and interest. Book III surveys historically "the different progress of opulence in different nations"; and Book IV, treating "of systems of political economy," criticizes Mercantilism and shows up its limitations. Book V examines "the revenue of the sovereign or commonwealth," and the rules there laid down respecting taxation and debts are still of practical guidance.

Again the conditions of the age were reflected in the current economic writings. The Industrial Revolution was in its infancy, and Adam Smith realized the necessity of removing restrictions, particularly on foreign trade. Not that he altogether severed himself from the Mercantilists; he still supported, for example, the Navigation Laws on the ground, as he put it, that defence was more important than opulence

Certain actions by authority in the name of economic freedom, commonly associated with Adam Smith (such as the refusal at first to introduce factory legislation, and the repression of labour organizations) were due to the special interpretation that his many followers put upon his writings rather than to the advocacy of the philosopher himself.

The contemporaries and successors of Adam Smith tended to suffer by comparison. *Malthus's* views on population would probably have been less pessimistic had he been able to foresee the results of man's inventiveness. *Bentham* was a jurist rather than an economist, but had considerable influence on economic thought and practice. His attack on the restrictive usury laws helped in bringing about their eventual repeal. The "utilitarian" school, whose object was "the greatest happiness of the greatest number," found much inspiration in his writings and leadership.

In his treatment Adam Smith employed both deductive and inductive systems of reasoning. *David Ricardo* drew most of his inspiration from Smith's work, but, not possessing the same historical sense, relied chiefly upon the deductive method of approach His "Principles of Political Economy and Taxation" (1817) showed a distinctly original line of thought. His theory of rent attracted wide support, and was developed by his successors into a theory which attempted to explain not merely the payment made for the use of land, but the remuneration that goes as "surplus" in greater or less degree to all the agents of production.

Following Adam Smith, Ricardo favoured a labour theory of value, but from his writings it is not clear whether in fact he did not envisage a more comprehensive cost theory, so as to embrace a return to capital. Labour was held to have its cost of production like everything else It will be noted below how the rent and value theories of Ricardo, a capitalist and millionaire, were converted by Lassalle, Marx and others into essentially Socialist doctrines. Understandably Ricardo came to be regarded as both "a prop and a menace to the middle classes."

Characteristic of Ricardo and his group was the cold, dogmatic method of treatment, which at times tended to become so abstract as almost to ignore the human factor. Their materialist and pessimistic doctrines earned for economics the epithet of " the dismal science." Economic laws were reduced to bald statements, and *N. W. Senior* ("Political Economy," 1836) was perhaps the most deductive and abstract of the school. His teaching rested almost entirely on the postulates that every man desires to obtain additional wealth with as little sacrifice as possible and that the population of the world is limited only by moral or physical evil or by fear of a deficiency of material comforts Senior also developed the abstinence theory of interest, which for a time was generally accepted.

These writers, who comprised the **Classical School,** made a considerable advance in economic analysis. Cost was taken as the basis of value, and welfare was considered to increase or decrease with the stock of wealth in existence. Their doctrines became the philosophical basis of the Manchester School, which was cosmopolitan in outlook and ardent in support of free trade between nations

The Classicists abroad employed a similar approach, but were less abstract and more nationalist in outlook. The German economist, *List,* in the "National System of Political Economy" (1841) advocated a system which in some ways was akin to Mercantilism. In France the tone was set by an idealistic liberalism. *Say* and *Bastiat* were the chief exponents, the latter going so far as to contend ("Economic Harmonies") that the organization of society which was due to competition was not only the best possible, but that it was also the best conceivable.

The time was ripe for the various doctrines to be brought together and systematized. The task was undertaken by *J. S. Mill,* who is sometimes regarded as the main successor to Adam Smith. Mill, too, was a social philosopher, and did much to widen the scope of economics. He did not add much that was new in the way of doctrine; his theory of the wages fund, for instance, was soon found to be defective. His chief work was to give economics a new spirit; he moulded it into something larger than a materialist and "dismal" science, and gave a prominent place to welfare besides wealth in his treatment.

Mill's later writings were not so individualistic in their attitude as his earlier works, though he still placed emphasis on the rights of the individual. He stated that "*Laissez-faire* should be the general practice; every departure from it, unless required by some great good, is a certain evil." Speaking of government interference, he concluded his "Principles" (1848) thus: "Even in the best state which society has yet reached, it is lamentable to think how great a proportion of all the efforts and talents in the world are employed in merely neutralizing one another. It is the proper end of Government to reduce this wretched waste to the smallest possible amount, by taking such measures as shall cause the energies now spent by mankind in injuring one another, or in protecting themselves against injury, to be turned to the legitimate employment of the human faculties, that of compelling the powers of Nature to be more and more subservient to physical and moral good."

From Mill onwards three main streams of thought and modes of approach may be discerned, pursued respectively by the Historical School, the Socialists and the Neo-Classicists

The attitude of the **Historical School** marked a reaction against the abstract systems which typified the previous economists. Its members placed emphasis on the inductive as opposed to the deductive method, contending that theories should be kept in close accord with realities, that hypotheses should constantly be tested by reference to known conditions and facts. In Germany the reaction against the old methods was very marked. *Roscher*, an early member of the school, maintained that political economy should be studied in close relation to the other social sciences; that in order to derive universal laws, study should be made not of one set of people, but of several, and particular attention should be paid to ancient races who, having run their full course, offered valuable lessons. He was followed by *Knies, Schmoller* and many others in Germany and elsewhere. In England the chief exponents of the historical method were *Rogers, Leslie, Toynbee, Cunningham* and *Ashley.*

Indications of Socialist thought are to be found in economic writings throughout the years from Plato to More In the eighteenth century *Rousseau* and *Godwin* developed the doctrine in the light of changing conditions. In the first half of the nineteenth century an academic and utopian form of Socialism was advocated by *St Simon, Fourier, Blanc* and others in France; and by *Owen* and *Thompson* in England. But Socialism did not gain much force until the second half of the century, when a new "scientific" approach was adopted. Its chief exponents were *Rodbertus* and *Marx,* with *Lassalle* as the militant organizer.

The new Socialism was termed "scientific" in contrast to the utopian ideas of the earlier writers. Karl Marx, who was the most potent force in the movement, was, like other German economists, historically minded; his "Capital" (Vol I, 1867) combines the results of acute observation and powerful abstract analysis. Adopting a "dialectic" method of investigation he attempted to show that the basis of society was economic; that the primary motive force of every kind of activity was the production of the means of life. He maintained that in modern communities there were two main classes, one possessing labour power, the other the physical means of production The latter class depended upon the appropriation of "surplus value," representing the difference between the productivity of labour and the payment which it received. Being a firm believer in the evolutionary process, Marx contended that the ownership and control of capital would become increasingly concentrated, involving a struggle between the classes and the eventual victory of the proletariat. Though much of Marx's doctrine has been modified, it still exerts considerable influence on Socialist thought and action, especially on the Continent.

There remain those economists whose methods resemble in some ways those of the old Classicists, and who, for want of a better name, have been termed the **Neo-Classical School.** Their method is chiefly deductive, but does not reveal such a tendency to over-abstraction that characterized the earlier writers. Historical research and the growing use of statistical records have served to check imaginative flights and to keep economic science within the bounds of reality. *Cairnes* (1874) restated the theory of value and introduced the conception of "non-competing groups." In a sense he was the link between the old and the new Classicists. *W. S. Jevons* introduced statistical and mathematical techniques. In his "Theory of Political Economy" (1871) and other works, he discussed the conception of final utility, and made a fruitful analysis of exchange, money and prices. Seventeen years beforehand, *Gossen,* a German economist, had published a theory of value based on utility, in which he had attempted to put economics on a mathematical basis

More psychological in approach were the Austrian economists, representative of whom were *Menger, Wieser* and *Böhm-Bawerk.* They are noteworthy as having developed the utility theory of value in refutation of the cost of production theory of the older Classical

School. Böhm-Bawerk in his "Positive Theory of Capital" (1888) conceived the notion that interest was the money-equivalent of the difference between present and future satisfactions. Several members of the Austrian school tended to be pre-occupied with the nature and determination of interest at the expense of other forms of income.

American writers have made noteworthy contributions to economic science. *Ely* and *Taussig*, for example, stressed the cost of production element in value and favoured a broad application of the Ricardian doctrine of rent to all forms of distribution. *Clark* and *Fisher*, adopting a subjective and psychological mode of analysis, were reminiscent of the Austrian School The main theme of Clark's "Distribution of Wealth" (1899) was the tendency under "static" conditions for the factors of production to receive shares corresponding to, and measured by, the productivity of their marginal increments. Fisher published several studies on capital and interest. Like Bohm-Bawerk he supported the *agio* or time-preference theory of interest; like Jevons he employed a mathematical technique

Chief among British economists at the beginning of the present century was *Alfred Marshall*, whose "Principles of Economics" (1890) and other works placed him in line with Adam Smith and J. S Mill. Though classical in outlook, he kept his reasoning in close accord with facts. He combined the deductive method with the inductive, abstraction with realism. He brought together the cost of production ideas of the Classicists and the utility doctrines of the Austrians, and formulated a more harmonious doctrine of value Especially significant was his belief in the principle of continuity. "There is a unity underlying all the different parts of the theories of prices, wages and profits. The remuneration of every kind of work, the interest on capital, and the prices of commodities are determined in the long run by competition according to what is fundamentally the same law. This law of Normal Value has many varieties of detail and takes many different forms. But in every form it exhibits value as determined by certain relations of demand and supply "

Important modifications have been made in economic doctrine and in the method of approach since the time of Marshall, notably the contributions of Keynes and other recent writers, to whom reference has been made in the foregoing text.

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